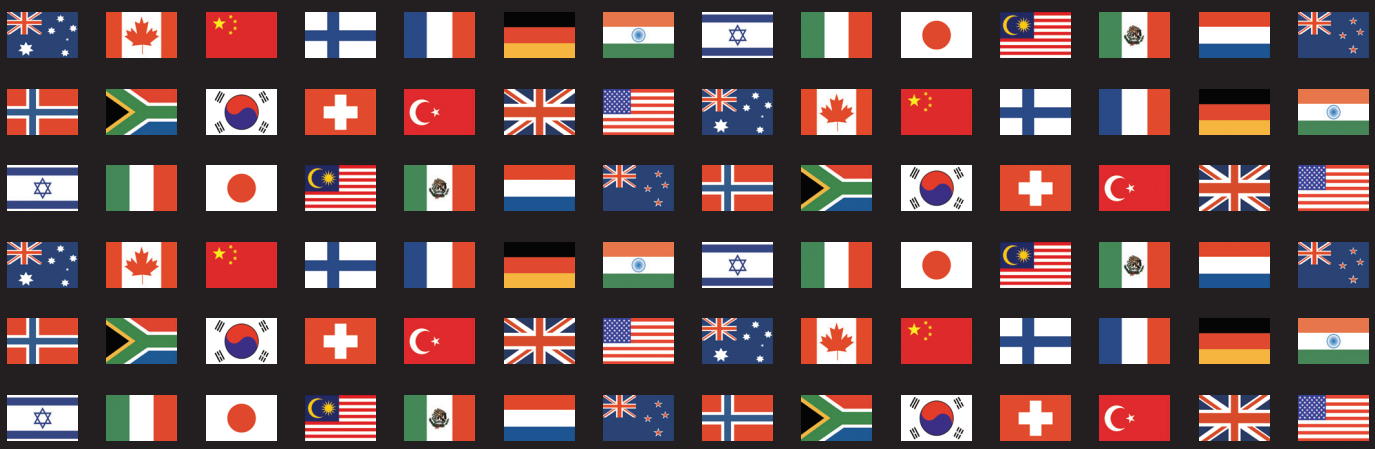
FRANCHISE 2023

Contributing editor
Mark Kirsch



LEXOLOGY
Getting the Deal Through

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Lexology Getting the Deal Through is delighted to publish the seventeenth edition of *Franchise*, which is available in print and online at www.lexology.com/gtdt.

Lexology Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting the Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes a new chapter on Turkey.

Lexology Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.lexology.com/gtdt.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Mark Kirsch of Lathrop GPM LLP, for his continued assistance with this volume.

LEXOLOGY
Getting the Deal Through

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Global overview

Mark Kirsch
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The world changed in 2020 and continued to change and evolve – in many ways. Individuals, businesses, and entire economies around the world have reacted to these changes, and also continued to evolve. The impact of the pandemic extended well beyond devastating worldwide illness and death. From the beginning of the pandemic, through the supply chain disruptions in 2021 and 2022, to the war in Ukraine, to the impact of global climate change, we were routinely reminded of how interconnected the world is, not only by the stunningly rapid spread of the virus across the globe, but by the impact on travel, hospitality, restaurants, healthcare, education and, of course, economies and industry.

However, a new sense of resiliency on the part of businesses, workers and consumers also emerged. Although individual businesses, certain industries and entire economies stumbled or collapsed (locally, regionally, nationally, and internationally), we also witnessed businesses that conserved resources, pivoted, survived, or hung on with government assistance, or found other ways to weather the pandemic and economic storms – only to be rocked by high inflation not seen in decades. Remarkably, some businesses even thrived. Companies accelerated investments in technology or developed new product and service offerings. The restaurant industry, which is home to many franchise brands, increased its investments in mobile technology and contactless payments, modified menu offerings, shifted to takeaway, and partnered with delivery companies to counteract the changes in consumption and travel habits. Education, tutoring and training businesses developed and implemented new virtual offerings. New businesses and services arose, such as 'ghost kitchens' (professional cooking facilities set up to provide delivery-only meals). Businesses found new consumers and new markets around the corner, across their home countries and around the globe. As we know, some companies saw the crisis, recognised the opportunities and acted. Those companies have come out on the other side stronger, and as a result, companies are rethinking their approaches to growth, development and expansion into new markets.

As the world – or some of it – got stronger in 2021 and into 2022 (but questions exist for 2023 and 2024), largely due to vaccine accessibility, businesses are starting to embrace the new normal and are evaluating new opportunities. Some companies that were doing business in a foreign country before the pandemic held on and are now looking to further expand or to jump-start that expansion. But many franchisors doing business in Russia have pulled out or ceased development due the war and international sanctions. Are they planning on deploying resources elsewhere? Other companies may wish to explore opportunities outside their borders for the first time and are ready to dip their toe in international franchise waters; others who may have been franchising or distributing in a foreign country pre-pandemic are now considering alternatives to expansion, with multiple approaches in different countries, such as direct franchising, master franchising, non-franchised licensing or distribution, or direct investment in company-owned outlets in a country. For all those companies, and for their in-house and outside counsel, *Lexology Getting the Deal Through: Franchise 2023* is a must-read for initial expansion diligence. Whether a company in Country A is looking to distribute its goods in Country B or is looking to expand its outlets and services to Countries C, D, E or F, understanding the commercial, financial, legal and regulatory landscape of those target countries is critical. This volume should be the first resource used to evaluate franchising and distribution issues in a particular country and guide strategic decisions.

Lexology Getting the Deal Through: Franchise 2023 is organised in the familiar style of a country-by-country analysis. Each chapter is written by a lawyer (or lawyers) with impeccable credentials and significant experience representing franchisors, master franchisees, sub-franchisors, franchisees, licensors and distributors in his or her country. Each chapter uses the same questionnaire that addresses the issues, business concerns and legal questions that most counsel and executives focus on as they embark on exporting their brand to a new country. Therefore, for the reader who wishes to dive into a particular country or several countries, each chapter discusses the relevant issues, moving from general to specific, much in the way counsel would prepare for a discussion with management. In general, each chapter guides the reader as follows:

- Each chapter begins with a market overview, describing franchising in that country and its role in business and the economy.
- The chapter proceeds to discuss basic business issues, such as business formation, taxation, restrictions on foreign investors, labour and employment, real estate and intellectual property.
- Next, each chapter explores franchise issues, going from the general to the specific, including the definition of a franchise, the laws and regulations governing franchising, franchisor eligibility and franchisee selection.
- Digging deeper, the chapter explores franchise-specific laws or other intellectual property, trademark, licensing, agency or competition laws. Our authors guide the reader through various aspects of the franchise process, such as franchise disclosure rules, registration and filing requirements, and even applicable general legal principles and codes of conduct.
- Each chapter also addresses the details and nuances of franchise agreements and the franchise relationship in each country, including restrictions on or arguments for terminations, renewals, transfers, fees, foreign exchange controls, confidentiality and non-competition covenants. As befitting any legal summary, each chapter discusses the court system, dispute resolution (including arbitration) and governing law requirements.
- Finally, each chapter wraps up with legal and other developments, and updates and trends.
- In addition, where applicable, the chapters provide links to the most critical and relevant laws and regulations accessible through the Lexology website.

However, business operations, including franchising and distribution into new markets and countries, are rarely implemented through a one-size-fits-all approach. Lexology Getting The Deal Through – Franchise

2023 allows the reader to evaluate each potential country on its own or create strategies for groups of countries. Because each chapter is organised in the same manner, the reader can identify, evaluate and analyse particular issues across several markets. Counsel may wish to evaluate one or more specific issues across multiple countries, weed out potential targets that are problematic, or focus efforts on better targets. For example:

- Company X is using direct franchising in its home country but wishes to explore alternative forms of franchising in other countries, such as master franchising or sub-franchising – this volume addresses each country's regulations and requirements as applied to different franchise models.
- Maybe Company X is considering a non-franchise licensing or distribution model and wishes to avoid granting franchises or becoming liable as an accidental franchise. This book will enable counsel to consider if the law in one or more countries could be a dead end because the current or proposed arrangement is a franchise. This permits a re-evaluation of the strategy for that country or a modification of the commercial arrangement.
- Will a country's tax structure or restrictions on foreign investment make entry into that country a non-starter, or are there restrictions or controls on foreign exchange that make repatriation of currency a challenge?
- If protections of confidential information, know-how and trade secrets is critical, will a particular target country be protective?
- If a company employs specific franchise agreement provisions for the protection of its system or for generating revenue, are those contract provisions permitted or enforceable in certain target countries?
- If a company designates specific suppliers, or controls pricing or resale prices in its home country arrangements or in certain foreign markets, a review of those portions of multiple chapters will assist the company and its counsel in mapping out an expansion strategy.
- Recognising that disputes with franchisees or master franchisees are likely to be inevitable at some point in the life cycle of franchise relationships, which countries are most hospitable to the company's desired dispute resolution procedures and which will enforce foreign judgments?
- Companies' plans change over time and at some point, the company may wish to withdraw from a market or country. Are there restrictions on terminations of franchises that may be an impediment?

Lexology Getting The Deal Through – Franchise 2023 is a valuable resource to evaluate franchising, whether in a neighbouring country to the reader's region, or in one or more countries on the other side of the globe. It is not, nor is it intended to be, a fulsome treatise on all aspects of franchising and franchise laws in over 20 countries with the goal to make the reader an expert in franchise law in those countries. This volume identifies the most significant issues that counsel, management, and their clients and companies need to know. Lexology Getting The Deal Through – Franchise 2023 provides guidance on these issues, as well as direction for where additional evaluation is needed. The reader will recognise that many issues will require consultation with local counsel in the target country. Additional analysis may be particularly necessary regarding non-franchise issues, such as entity formation, taxation and labour. Additional research will be needed with respect to franchise-specific issues, such as disclosure and registration, permitted contract clauses or franchise terminations. An in-house lawyer, in-house executive or a company's outside counsel may not be comfortable with turning over all the questions and issues to foreign counsel. This volume will arm the reader with information to ask intelligent questions of foreign counsel. When seeking out counsel in another country, what better source than the author who wrote the relevant chapter.

Let me take this opportunity to thank the group of authors who have contributed to this book. They have spent years honing their skills and knowledge, and have shared it with the readers in an extremely user-friendly manner.

Business opportunities and challenges are different than they were pre-pandemic. However, one thing has not changed: the need for lawyers and executives to intelligently analyse and evaluate business growth opportunities to provide their clients with the best advice in an efficient manner, so that both counsel and clients can make sound strategic decisions. The world has changed, and businesses and commercial relationships are continuing to evolve – are you poised to act?

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Franchising is a well-established and credible business method in Australia, with franchise systems operating in most industry sectors. According to the Franchise Council of Australia (FCA), there are 1,344 franchise systems in Australia, with an estimated 98,000 units turning over A$184 billion and employing more than 598,000 people. The most recent industry survey in 2016 found that 26 per cent of franchisors were in non-food retail, 19 per cent in accommodation and food services, 15 per cent in business services (including travel agencies, office services, domestic and commercial cleaning, gardening services and lawn mowing) and 10 per cent in personal and other services (including pet grooming, automotive repairs and information technology services). Ninety-two per cent of the franchise systems reported that they were Australian-based operations.

Australia has a robust economy that has continued to perform strongly during the covid-19 pandemic. The impact of the pandemic has been limited by prompt, effective lockdown measures and a well-targeted government support and stimulus package. The main implication for foreign franchise systems was the restriction on travel to or from Australia. The Federal government also reviewed any foreign investment in Australia very closely during this period. Australia has subsequently opened up slowly to international travel in the first half of 2022.

The Australian market is relatively mature and highly competitive. Although many foreign systems have successfully entered the market, there have also been a substantial number of failures. The biggest challenge in a mature competitive market is achieving critical mass, which in turn can be dependent upon the level of commitment of the brand to the market and the quality and resources of any chosen local partner. For retail franchise systems, access to prime sites can also be challenging, although much retail is conducted at major shopping malls that are keen to provide opportunities for new concepts.

More broadly, foreign franchise systems entering the Australian market typically find the market to be a high-cost market. Labour rates are high by international standards, with a high minimum wage and penalty rates for out-of-hours work that often surprise foreign franchise systems. Real estate can be difficult to secure, with property rentals and energy costs high by international standards, particularly in major shopping centres. Foreign franchise systems seeking to enter the market should carefully review their cost structures as part of their market due diligence.

Australia has a sophisticated legal framework that includes specific regulation of franchising, foreign investment, and competition and consumer matters. There are significant compliance obligations that affect the way activities are conducted, but none of these laws are likely to materially impact the viability of franchising activities in Australia.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The Franchise Council of Australia (FCA) is the peak industry body, which acts as a trade association to represent the franchise sector in dealings with government. The FCA also provides a range of educational publications and programmes, franchise promotional activities, networking events, and member services for franchisors, franchisees and suppliers. The FCA has a set of member standards and guidelines that apply to FCA members, but they do not have the force of law. The Franchising Code of Conduct and the Australian Consumer Law are the laws most relevant to franchising. They are federal laws that apply uniformly throughout Australia.

The Federal Chamber of Automotive Industries is the peak industry body for the automotive sector. There are also various bodies representing automotive franchisees or dealers.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

Franchisors will typically trade as a corporate entity formed under the Corporations Act 2001 (Cth). Most franchisors are private companies, but there are some listed or unlisted public companies. However, there are no restrictions on using other vehicles such as a joint venture, partnership or trust to establish a franchise system.

Typically, a corporate franchisor entity will be part of a consolidated group, with other entities potentially holding intellectual property or real estate, operating company outlets or supplying goods or services to the franchise network.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

The Corporations Act 2001 (Cth) is a federal law regulating the formation of corporations, and the ongoing conduct of corporations and directors. The Australian Securities and Investment Commission (ASIC) oversees

this legislation. This is the primary regulatory framework relevant to the formation of business entities.

Partnership structures are under the jurisdiction of state and territory legislation, as are business name registration laws that can impact the business conducted by franchisees. Similarly, trust structures are subject to the supreme courts of each state and territory through the equity divisions.

Requirements for forming a business

5 | Provide an overview of the requirements for forming and maintaining a business entity.

The first step in forming a business entity is to decide on an appropriate business structure. The most common types of structure are company, trust, joint venture and partnership. Tax considerations play an important role in determining the choice of entity for commercialisation of a franchise system. A company structure must be registered with ASIC.

Before applying to register a company with ASIC, written consent must be received from individuals who have agreed to be a director, secretary or shareholder. Each director must hold a director identification number, before being appointed as a director of the company. The director identification number must be obtained from the Australian Business Registry Services (ABRS). This requires the director to have their personal identification documents verified.

Every company must have at least one shareholder. All companies conducting business in Australia are required to have at least one Australian-resident director. A registered office and principal place of business must also be nominated.

Once ASIC has processed the application, the entity will be given an Australian company number, which can be used to apply for an Australian business number (ABN). An ABN is necessary for trading purposes.

Each company will be required to complete annual compliance requirements, for example, passing a solvency resolution, filing financial reports (in some cases) and paying an annual review fee.

ASIC also requires companies to keep written financial records, for a minimum of seven years, that:

- record and explain their financial position and performance; and
- enable accurate financial statements to be prepared and audited.

Restrictions on foreign investors

6 | What restrictions apply to foreign business entities and foreign investment?

Generally, foreign business entities can transact as such with Australian entities. The decision to establish a business presence in Australia must be carefully considered, as there are significant consequences.

A foreign company wishing to establish a business presence in Australia must either register itself with ASIC as doing business in Australia, or establish or acquire an Australian subsidiary company.

A foreign entity conducting business in Australia may also be required to register with the Australian Tax Office (ATO) and pay taxes in Australia. This depends on whether there are any applicable tax treaties, and the nature and scale of the business. The ATO takes an active role in monitoring profit shifting between jurisdictions.

Foreign investment in Australia is regulated by the Foreign Acquisitions and Takeovers Act 1975 (Cth) and its related regulations. The legislation is supported by Australia's foreign investment policy and guidance notes. Certain proposals by foreign persons to invest in Australia require prior notification to and the approval of the treasurer of Australia. The treasurer is advised by the Foreign Investments Review Board (FIRB). However, the legislation only applies to particular transactions and monetary thresholds apply in most cases. Special rules apply to certain transactions, including transactions involving land-rich entities, national security businesses, government investors and others. Some transactions are not subject to a monetary threshold (for example, transactions involving investment in national security business, which is broadly defined).

Although investments in industries typically relevant to franchise systems (such as retail, services and food) do not usually require notification as they are likely to be below monetary thresholds, there were temporary changes introduced on 29 March 2020 as a result of the covid-19 pandemic that impacted all foreign investments by reducing the monetary thresholds on all investments to A$0. These temporary measures were subsequently removed, although a broad prohibition on investments that may raise national security concerns mean that these investments still have an A$0 threshold. Therefore, each transaction should be considered on a case-by-case basis to determine whether FIRB approval is required.

Taxation

7 | What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

Australia has a sophisticated federal taxation system. Net income and capital gains are subject to taxation, and a comprehensive goods and services tax (conceptually akin to value added tax) is imposed on most transactions. Taxes on payroll and property transactions are levied at a state level, and local government levies apply to owned properties to cover utility services. The framework is complex, and specific taxation advice should be obtained in relation to its structure and operating arrangements. Different arrangements apply depending on whether the franchisor is resident in Australia for tax purposes or a foreign entity.

Typically, all amounts derived by an Australian resident franchisor – whether for initial fees, goodwill on any sale of business or ongoing royalties or other items – is received as income. From the franchisee's perspective, the initial franchise fee is likely to be considered a capital payment and is not eligible for deduction from the franchisee's income. However, this fee is relevant as part of the cost base when calculating any future taxable capital gain or loss. Royalties and ongoing fees are tax deductible for a franchisee. Payments made by a franchisee to the franchisor (such as initial franchise fees, franchise renewal fees, franchise service fees or royalties, advertising fees, transfer fees and training fees) generally incur goods and services tax (GST), which is 10 per cent as at May 2022. A franchisee that is GST-registered can claim a credit for the GST paid from the ATO.

Where the franchisor is incorporated or considered to be a resident of Australia (applicable to both corporations and individuals), it will be taxed in Australia in accordance with Australian law. If the franchisor is not a resident of Australia, a withholding tax regime applies to payments made from Australia to the franchisor. The rate of the withholding payment depends on the nature of the payment and other factors, including whether the franchisor resides in a country with which Australia has a double taxation agreement. The Australian resident franchisee or master franchisee is generally required to withhold a flat rate of 30 per cent from the gross amount of a royalty payment and 10 per cent from the gross amount of an interest payment. These amounts are paid to the ATO and are included on the franchisee's activity statement. A non-resident franchisor that is subject to a double taxation agreement may be eligible for a reduction of these rates if the appropriate amount has been reported, withheld and paid to the ATO. It is necessary to consider whether the GST is payable in relation to franchisee payments to a foreign franchisor, as in certain circumstances it may not be.

Terminating or transferring a franchise agreement may have tax implications for the franchisee, as may any amount received in settlement of a dispute.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

Australia has comprehensive labour laws covering workplace health and safety, workers compensation, sick leave, long service, and compulsory pension contributions. Labour rates are high by international standards, with high minimum wages and penalty rates for out-of-hours work that often surprise foreign franchise systems.

Although many jurisdictions have contemplated extending the responsibility of franchisors to the workplace law obligations of their franchisees, Australia has been the first to legislate such an obligation. Section 558B was introduced to the *Fair Work Act 2009* by the Fair Work Amendment (Protecting Vulnerable Workers) Act 2017 to make a responsible franchisor entity liable for workplace law breaches of a franchisee in certain circumstances.

The legislation provides that a responsible franchisor entity is liable for certain contraventions of the Fair Work Act 2009 by an employer that is a franchisee entity where the franchisor or an officer of the franchisor, 'knew or could reasonably be expected to have known that the contravention by the franchisee entity would occur, or a contravention of the same or similar character was likely to occur'. Section 558(3) and (4) of the amendment set out a defence for a person (which would include a responsible franchisor or an individual that aids and abets a breach) that takes reasonable steps to prevent the contravention.

The legislation links back to the much broader Corporations Act 2001 (Cth) definition of a franchise, rather than that contained in the Franchising Code of Conduct (the Code). Section 9 of the Corporations Act 2001 (Cth) defines a franchise as:

> *an arrangement under which a person earns profits or income by exploiting a right, conferred by the owner of a right, to use a trade mark or design or other intellectual property or the goodwill attached to it in connection with the supply of goods or services. An arrangement is not a franchise if the person engages the owner of the right, or an associate of the owner, to exploit the right on the person's behalf.*

Many licence and distribution arrangements are likely to fall within the ambit of the legislation.

Franchise systems looking to do business in Australia must obtain specific advice on the extent of their potential liability and the steps they must take to ensure they can either escape the ambit of the legislation or satisfy the test of taking reasonable steps to prevent contraventions.

Franchise systems where the franchisee derives income largely from the individual franchisee's personal exertion must be watchful of sham contractor laws or franchisees being deemed employees. However, this risk is manageable, including by ensuring franchisees are incorporated entities rather than individuals.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

Trademarks and other intellectual property are protected through registration with IP Australia. Australia is a first-to-register rather than first-to-use jurisdiction, so foreign franchise systems must focus on trademark protection well in advance of market entry. There are several classes (ie, goods or services) to which registration can attach. The protection afforded by initial registration is 10 years with the ability to renew on application.

Trademark registration in Australia also facilitates applications for registration in most overseas jurisdictions if they are party to the relevant treaties. The list of countries in which a priority registration can be claimed is determined by the signatories to the Paris Convention of 1979, as amended, with signatory countries listed in the regulations to the Trade Marks Act 1995 (Cth).

The phrase 'trade secret' refers to the type of confidential information associated with commercial purposes, defined as 'a device, or technique used in a particular trade or occupation and giving an advantage not generally known'. Trade secrets are protected without registration and there are statutory acknowledgements, such as prohibitions on the improper use by employees of this information, under the Corporations Act 2001 (Cth).

Trade secrets are also protected by equity and careful contractual drafting in franchise agreements. Remedies against breach are founded on allegations of breach of confidentiality. It must be established that the information has the necessary quality of confidence and was conveyed in circumstances where the confidence obligation was evident, and that there was unauthorised use causing detriment. There is also a requirement that the trade secret has a nexus to a trade or occupation.

Copyright protection applies to documents and other works, and vests in the author by virtue of the Copyright Act 1968 (Cth) without the need for registration. There is also federal legislation to protect patents and designs.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

The vast majority of franchised businesses operate from leased premises, with exceptions only common in the petroleum, automotive and hotel sectors. Major brands often take the head lease of premises, then grant an occupancy right to the franchisee. Smaller franchise systems may permit the franchisee to hold the lease, preferring to avoid the liability to the owner of the premises should the franchised business fail. Shopping mall proprietors often insist on the brand owner holding the head lease. Hybrid arrangements, wherein the franchisee holds the lease but the brand owner has contractual step-in rights if the franchisee fails, are also possible, particularly in the restaurant and casual dining sector.

Property law is state-based rather than federal and premises are often also subject to planning laws enacted by local government. Franchise systems seeking to occupy premises in major shopping malls should consider obtaining expert assistance, as rentals can be a high percentage of turnover and lease terms can be one-sided and onerous. Food businesses are particularly vulnerable to the continued introduction of new competitors. There is usually a significant information imbalance between mall owners and tenants.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

The Competition and Consumer Act (CCA) is a federal law that regulates business conduct in Australia, promoting fair and effective competition and consumer protection. The CCA is administered by the Australian Competition and Consumer Commission (ACCC), which takes an assertive and public role in enforcement. This role is in addition to the supervision of compliance with the Code. The ACCC may act at any time against a franchisor for non-compliance with the Code. The ACCC is also the first point of contact for reporting serious franchisor non-compliance.

The CCA and the Australian Consumer Law (ACL), which is incorporated in Schedule 2 of the CCA, makes certain conduct (including misleading or deceptive representations, unconscionable conduct, third line forcing and resale price maintenance) illegal. Disclosing illegal conduct in the disclosure document does not prevent that conduct from being a breach of the CCA. The important sections of the CCA and the ACL that must be kept in mind are the following.

- Section 18 of the ACL prohibits misleading or deceptive conduct. Section 4 of the CCA augments section 18 by providing that a person making any statement as to a future event (such as a projection of turnover) must be able to prove they had reasonable grounds for making it.
- Section 22 of the ACL provides that a corporation must not, in trade or commerce, engage in conduct that is, in all circumstances, 'unconscionable'.
- Chapters 2, 3 and 4 of the CCA, which contain a whole range of prohibitions against restrictive trade practices such as price fixing, misuse of market power, resale price maintenance and covenants affecting competition.

Contravention of the provisions of the CCA can result in severe penalties. In the case of breaches of some provisions in Chapters 2, 3 and 4, including the price-fixing provisions, these penalties can include fines up to A$500,000 for individuals. For corporations, fines can be up to the greater of:

- A$10 million;
- three times the value of the benefit attributable to the breach (when that value can be ascertained); or
- 10 per cent of the corporation's annual turnover when the value of the benefit attributable to the breach cannot be ascertained.

However, it is possible for certain conduct to be authorised or enforcement action avoided by using the ACCC's authorisation or notification processes. These processes can be helpful in tied-supply situations or where there is a technical breach of the CCA, but the conduct has little commercial impact or there is a public benefit associated with the conduct.

The ACCC has a range of enforcement options open to it. When choosing which option to take, the ACCC assesses how blatant the breach is, the public detriment, the educative effect and if it must create a new law or a new market issue. When assessing appropriate enforcement action for breach of the Code, the ACCC may also investigate, among other things, whether franchisors have effective compliance systems in place to prevent further problems in relation to compliance with the Code and the CCA.

The ACL was amended in 2015 by legislation that prohibits unfair terms in standard form small business contracts (see the Treasury Legislation Amendment (Unfair Contract Terms) Act 2015), in effect as of 12 November 2016. As a small business is defined as a business with fewer than 20 employees and a typical franchise agreement exhibits many of the characteristics of a standard form contract, the legislation has significant potential application to franchise agreements. Foreign and domestic franchise systems must carefully consider the application of the unfair contract provisions of the ACL to their franchise agreement and other documentation.

If the court declares a provision of a contract unfair, that provision will be void. The contract does, however, continue to bind the parties if the contract can operate without the unfair term. There are legislative amendments currently under consideration that would introduce penalties for the inclusion of an unfair contract term into a standard form small business contract. If enacted, these amendments are likely to be a game-changer for businesses, as it will no longer be possible to take a 'wait and see' approach as to whether a court determines a clause to be an unfair term.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

The application of the Franchising Code of Conduct (the Code) is largely determined by the definition of a franchise agreement, which is broadly described as an agreement that takes the form, in whole or in part, of a written, oral or implied agreement. The Code defines a franchise agreement in clause 5(1), including in its definition any form of franchise, master franchise, licence or distribution agreement. The essence of the definition is as follows:

> *[An agreement] in which a person (the franchisor) grants to another person (the franchisee) the right to carry on the business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor.*

The definition has two requirements:

- that 'the operation of the business will be substantially or materially associated with a trade mark, advertising or commercial symbol owned, used or licensed by the franchisor or an associate of the franchisor; or specified by the franchisor or an associate of the franchisor'; and
- that 'before starting the business or continuing the business the franchisee must pay or agree to pay to the franchisor or an associate of the franchisor an amount, including for example an initial capital investment fee, a payment for goods and services or a fee based on a percentage of gross or net turnover whether or not called a royalty or franchise service fee, or a training fee or training school fee'.

The only exemption to the application of the Code is a fractional franchise exemption where sales under the franchise are no more than 20 per cent of the franchisee's gross turnover. All motor vehicle dealerships (being a business of buying, selling, exchanging or leasing any form of motor vehicle, however structured) are deemed to be franchise agreements. There are additional provisions in the Code, mainly in relation to end of term arrangements and capital expenditure, that only apply to automotive franchise agreements. Oil industry franchise agreements are subject to different, but similar, legislation known as the Oil Code of Conduct.

Following the introduction of amendments to the Code in April 2022, franchisors are now required to register with the Franchise Disclosure Registry. This must be done by November 2022, when the registry will become live for all franchisors' profiles and documents to be publicly searchable.

There is no state regulation of franchising in Australia other than the legislation in South Australia that relates to the resolution of disputes in franchise agreements connected to South Australia. Franchisors are also able to conduct meetings and generally undertake preliminary marketing and prospecting in Australia, but may not enter into a binding agreement or take any non-refundable amount from a prospective franchisee or master franchisee without complying with the Code.

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

The Code and the prohibitions on misleading or deceptive conduct contained in the Australian Consumer Law (ACL) regulate the offer and sale of franchises.

Principal requirements

14 What are the principal requirements governing the offer and sale of franchises under the relevant laws?

The Code includes comprehensive disclosure and franchise relationship provisions. It is supplemented by prohibitions on misleading or deceptive conduct, unconscionable conduct and unfair contract terms in standard form small business contracts contained in the ACL. Amendments to the Code that took effect on 1 July 2021 also extend the 14-day cooling-off period to franchisee-to-franchisee sales.

Franchisor eligibility

15 Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

There are no eligibility requirements for franchisors before they can offer franchises.

From November 2022, most franchisors will be required to register and provide certain information about their franchise to the Franchise Disclosure Register. This includes the name, Australian business number, registered address, and contact details of the franchisor. Certain other information may be prescribed for inclusion in the franchisor's registration. This information will need to be updated annually. Franchisors may also elect to upload their franchise agreement, disclosure document and key facts sheet. These documents must not include personal information.

The comprehensive Code pre-contractual disclosure process and the prohibition on engaging in misleading or deceptive conduct contained in the ACL place some natural barriers to entry in a competitive market, particularly where franchisees follow the Code's process and obtain legal and business advice prior to signing the franchise agreement.

Franchisee and supplier selection

16 Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

There are no legal restrictions or requirements in relation to the manner in which a franchisor recruits franchisees or selects its own or its franchisees' suppliers. Supply arrangements must be disclosed in the disclosure document, with amendments to the Code in effect as of 1 July 2021 significantly expanding disclosure obligations in relation to rebates and financial benefits. The general prohibition on unconscionable conduct contained in the ACL can apply if the mandated supply chain arrangements are unnecessarily onerous or place the franchisee at a substantial competitive disadvantage.

Pre-contractual disclosure – procedures and formalities

17 What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

There are two pre-contractual disclosure obligations under the Code in Australia. Franchisors must provide an information statement (essentially a brochure on the advantages and disadvantages of franchising) in the prescribed form to a prospective franchisee at the earliest opportunity after the prospect formally expresses interest in a franchise (which must not be later than seven days). The intent of this disclosure obligation is to highlight the potential risks of franchising and emphasise the importance of due diligence to prospective franchisees well before they decide to enter into the franchise agreement. The information statement must be in the form prescribed, which is available on the Australian Competition and Consumer Commission's (ACCC's) website.

In addition, franchisors are required to produce a disclosure document that strictly complies in form and content with the terms of Annexure 1 (full form) of the Code. The disclosure document is required to be 'in the form and the order and under the numbering' and 'under the titles' set out in the annexures to the Code. Although some of the information contained in existing disclosure materials assists in the preparation of the Australian document, foreign systems must instruct local counsel to undertake a comprehensive redraft to meet the format requirements of the Code. Supplementing the general disclosure obligation is a Code requirement to provide a key facts sheet in the prescribed form. The key facts sheet is, in essence, a summary of important facts contained in the disclosure document. The prescribed information statement and the form of the key facts sheet are now accessible on the ACCC's website.

Certain modifications to the franchise agreement must be made concerning releases of liability, franchisee freedom of association, cooling-off periods, assignment and termination. A franchisor is prohibited from passing on to franchisees a franchisor's legal costs, subject to very limited exceptions. There are also provisions limiting termination, providing cooling-off protections and dealing with dispute resolution, including mechanisms for group franchise dispute resolution.

A general review of documentation for Competition and Consumer Act compliance is also highly desirable, as the terms and language of a franchise agreement are relevant in assessing conduct such as unconscionable conduct. Plain-English drafting is highly desirable.

A franchisor must, under the Code, give a disclosure document and a key facts sheet to a prospective franchisee or a franchisee proposing to renew or extend a franchise. A franchisor must give a copy of the Code and a disclosure document to a prospective franchisee at least 14 days before the prospective franchisee:

- enters into a franchise agreement;
- makes an agreement to enter into a franchise agreement; or
- pays non-refundable money to the franchisor or an associate of the franchisor in connection with the proposed franchise agreement.

The franchisor must also provide at this time a copy of the franchise agreement 'in the form in which it is to be executed', which means that the document must contain all commercial terms and be essentially ready to be signed. Failure to comply with this requirement can invalidate disclosure and is a pitfall for foreign franchisors that are used to providing more of a template franchise agreement with the disclosure material.

A foreign franchisor entering into a master franchise agreement with a master franchisee that has the right to grant unit franchises and sub-franchises in Australia must also provide to the master franchisee a disclosure document relating to the terms of the master franchise agreement. As of 1 January 2015, a franchisor is required to give a disclosure document to a master franchisee, but the franchisor is not required to give a disclosure document to a sub-franchisee of the master franchisee. These disclosure requirements can create potential liability for foreign franchisors, so it is important that legal advice from an experienced franchise attorney is obtained regarding the form of these documents before entering into the Australian market.

Franchisors are required to update their disclosure document annually within four months of the end of their financial year. They are also required to provide a copy of their current disclosure document to an existing franchisee within 14 days of written request. However, there are some exemptions from updating for franchisors that have granted no more than one franchise agreement in the year and do not intend to grant a franchise in the following year.

The Code contains somewhat unusual provisions in relation to legal and business advice, and to cooling-off periods:

- A franchisor must not, by virtue of the Code, enter into, renew or extend a franchise agreement unless the franchisor has received from the franchisee or prospective franchisee a written statement that the franchisee or prospective franchisee has received, read and had a reasonable opportunity to understand the disclosure document and the Code.
- Before a franchise agreement is made, the franchisor must have received from the prospective franchisee signed statements that the prospective franchisee has been given advice about the proposed franchise business from at least one independent legal adviser, business adviser or accountant, or has been told that this advice should be sought but has decided not to seek it.
- A franchisee may terminate a franchise agreement without cause within 14 days after entering into the agreement or paying any money under the agreement, whichever comes first. If the franchisee terminates such an agreement, the franchisor must, within 14 days, repay all money paid by the franchisee to the franchisor under the agreement less reasonable expenses, provided that those expenses have been disclosed in the disclosure document provided to the franchisee.

Pre-contractual disclosure – content

18 | What information is the disclosure document required or advised to contain?

The disclosure requirements are complex and highly prescriptive. The disclosure document must be in the prescribed form and layout and under the headings prescribed in the Code.

Comprehensive disclosure is required for:

- franchisor details;
- business experience;
- litigation history;
- existing franchisees (which must be listed);
- intellectual property;
- site or territory information;
- supply of goods or services;
- establishment or operating costs;
- the operation of marketing funds;
- financing;
- end of term arrangements; and
- financial details.

Although a franchisor's current foreign disclosure document's content is useful, it cannot be used for compliance as significant additional information is typically required in Australia.

Pre-sale disclosure to sub-franchisees

19 | In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Disclosure to sub-franchisees is typically undertaken by the sub-franchisor, as it is the 'franchisor' for the purposes of a franchise agreement in the Code. Joint disclosure may be required if the franchisor is also a party to the franchise agreement, so this should be avoided if possible.

Item 7 in the disclosure document to be provided by the sub-franchisor to the sub-franchisee includes specific disclosure obligations concerning the franchisor in relation to business details, senior employees and franchise agreement termination. It also includes key provisions of the franchise agreement between the franchisor and the sub-franchisor, such as the agreement's term, territory, renewal, extension, scope, transfer, termination and consequences of termination.

Item 8 in the disclosure document requires information to be provided in relation to ownership of intellectual property and details of any agreement that significantly affects the sub-franchisor's right to use or give others the right to use the intellectual property. This is likely to require some disclosure in relation to the agreement between the franchisor and the sub-franchisor.

Due diligence

20 | What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

The Code provides a strong framework for franchisee due diligence, combining preliminary disclosure through the information statement with the more common formal pre-contractual disclosure process. The information statement broadly explains franchising, the franchise relationship and the risks of franchising, and outlines how to undertake due diligence, obtain advice, read documents, understand the franchisee's rights and obtain further information. The disclosure document contains extensive information, and is provided as part of a process that allows 14 days between provision and signing to facilitate obtaining legal and business advice. Not only is obtaining advice strongly encouraged, but franchisees must certify as part of the pre-contractual process that they have obtained advice or have been told to obtain advice but have elected not to do so. A list of franchisees' and former franchisees' contact details is provided as part of the disclosure document, which is an excellent reference point. Franchisees should speak to several existing and former franchisees, read documentation carefully, and obtain legal and business advice.

Franchisors should conduct their own due diligence of prospective franchisees, particularly in relation to financial resources, business acumen and customer service skills.

Failure to disclose – enforcement and remedies

21 | What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

In situations of material and substantive non-disclosure by a franchisor, a franchisee can take legal action via civil proceedings to obtain various common law and equitable remedies, including damages, rescission, injunctions and other orders a court may deem fit. Damages are typically calculated by reference to the actual damage suffered by the franchisee and can be awarded in addition to other remedies such as rescission, amendment or termination of the franchise agreement, or other order a court may see fit.

In addition, the ACCC takes an active enforcement role. The ACCC has the power to investigate and seek penalties for contraventions of the Code. The ACCC's use of enforcement tools varies on a case-by-case basis depending on the circumstances of the contravention. Where there are reasonable grounds for believing a contravention of a penalty provision has occurred, the ACCC can issue an infringement notice of A$11,100 to a franchisor without the need to apply to any court. The ACCC can also enforce the Code by court proceedings with the power to seek a civil penalty of A$133,200 for each contravention. Additionally, the ACCC can obtain orders against the franchisor that include compensation and damages, disqualification of directors, and injunctions. The ACCC also has the power to accept formal undertakings by which a franchisor can commit to specific remedies for the breach.

Some provisions of the Code contain greater financial penalties. These provisions relate to:

- disclosure of materially relevant facts;
- restricting the freedom of association of franchisees or prospective franchisees; and
- certain terms of new vehicle dealership agreements.

For companies, the maximum penalty per contravention will be the greater of:

- A$10 million;
- three times the value of the benefit received; or
- 10 per cent of annual turnover in the preceding 12 months, if a court cannot determine the benefit obtained from the offence.

For individuals, the maximum penalty per contravention will be A$500,000.

Often action in relation to disclosure breaches is coupled with claims for misleading or deceptive conduct, or unconscionable conduct (or both), which attract higher financial penalties. Recent cases have seen damages awards in excess of A$2 million against franchisors that have breached the Code and the ACL, such as *Australian Competition and Consumer Commission v Ultra Tune Australia Pty Ltd* [2019] FCA 12, and *Australian Competition and Consumer Commission v Geowash Pty Ltd (Subject to a Deed of Company Arrangement)* (No 4) [2020] FCA 23.

Failure to disclose – apportionment of liability

22 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

As a general rule, liability rests with the party legally obliged to comply with the law under the Code and the ACL, which is usually the sub-franchisor. However, both laws include potential liability for corporations and individuals that aid, abet, counsel, procure or are knowingly involved in any breach. Liability relates both to pecuniary penalties under the legislation and to civil damages claims. In the case of serious breaches of the law, it is common for action to be taken against individuals knowingly involved in the breach.

General legal principles and codes of conduct

23 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

The offering and selling of a franchise is a commercial dealing subject to the provisions of the ACL contained in Schedule 2 of the Competition and Consumer Act 2010 (Cth). The ACL governs the conduct of both the franchisor and franchisee in such dealings and, among other things, prohibits them from engaging in conduct that is unconscionable, misleading, deceptive, or likely to mislead or deceive.

General common law contract principles also apply to franchise agreements. These principles can affect the validity and enforceability of a franchise agreement depending on the terms of the agreement, surrounding circumstances, and conduct of the parties prior to and after its execution. For example, a franchise agreement may be avoided where misleading or deceptive conduct, duress, unconscionable conduct, or undue influence has taken place.

There are a number of mandatory industry codes in Australia that may apply to the franchise agreement and are enforceable by the ACCC including:

- the Food and Grocery Code of Conduct;
- the Horticulture Code of Conduct;
- the Oil Code of Conduct; and
- the Unit Pricing Code.

Additionally, voluntary industry codes may apply to parties to franchise agreements where they have elected to be bound by them.

Fraudulent sale

24 What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

Under the ACL, several remedies are available to a franchisee where a franchisor has engaged in fraudulent or deceptive practices regarding the offer and sale of a franchise. These remedies include the voiding or varying of parts or the entirety of the franchise agreement, monetary damages and orders (or injunctions) compelling certain actions by the franchisor.

Under common law contract principles, a franchisee may obtain an order of rescission whereby the franchise agreement is rendered void and unenforceable. Additionally or alternatively, a franchisee may be awarded monetary damages.

FRANCHISE CONTRACTS AND THE FRANCHISOR/ FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

Franchising in Australia is, in essence, a contractual relationship supplemented by specific requirements contained in the Franchising Code of Conduct (the Code) including the obligation to act in good faith. In many cases, franchising is subject to the general prohibition on unfair contract terms in standard form small business contracts.

The general prohibitions on misleading or deceptive conduct and unconscionable conduct contained in the Australian Consumer Law (ACL) apply to regulate the ongoing relationship between franchisor and franchisee.

Unfair contract terms

Franchise agreements should be reviewed to assess if the prohibition on unfair contract terms applies to the agreement. As a small business is defined as a business with fewer than 20 employees and a typical franchise agreement exhibits many of the characteristics of a standard form contract, the legislation has significant potential application to franchise agreements.

There are some exclusions, such as agreements in which the upfront fee is more than A$300,000 (or A$1 million for a contract with a term of more than a year) and certain special types of contract. Further, where an agreement, including a franchise agreement, is negotiated and there are genuine opportunities for amendment, it may not be considered a standard form contract presented on a 'take it or leave it' basis.

If the prohibition applies, a more detailed assessment of the contractual provisions should be conducted. The legislation gives numerous examples of provisions that could potentially be unfair, including a term that:

- permits one party (but not another party) to avoid or limit performance of the contract;
- permits one party (but not another party) to terminate the contract;

- permits one party (but not another party) to vary the terms of the contract;
- limits one party's liability or right to sue; or
- permits one party to assign the contract to the detriment of another party without that other party's consent.

The legislation provides that a provision in a small business contract is unfair if the contract:

- would cause a significant imbalance in the parties' rights and obligations arising under the contract;
- is not reasonably necessary to protect the legitimate interests of the party that would be advantaged by the term; and
- would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied upon.

For a court to declare that a term is unfair, all three of the above elements must be proven.

The burden of proof is on the party advantaged by the term to prove it is reasonably necessary to protect its legitimate interests. In determining whether a term is unfair, the court may take into account such matters it considers relevant, but must take into account the extent to which the term is transparent and the context of the provision in the contract as a whole.

Generally, few changes are likely to be necessary to template documentation, with the main areas of focus likely to be in relation to provisions dealing with liquidated damages, altering or purporting to exclude legal liability, termination and dispute resolution. If a court declares a provision of a contract to be unfair, that provision is void. However, the contract continues to bind the parties if it can operate without the unfair term. This legislation is currently under review. Possible legislative amendments to introduce penalties for the inclusion of an unfair contract term into a standard form small business contract would be a game-changer for businesses, as it would no longer be possible to take a 'wait and see' approach on whether a court determines a clause to be an unfair term.

The Franchising Code of Conduct

Clause 6 of the Code obliges each party to a franchise agreement to act in good faith, essentially codifying the common law good faith obligation but also extending it to specific franchising situations, such as any matter arising out of the Code, negotiation of the franchise agreement and disputes.

If, as part of the franchise scheme, the franchise agreement provides that a franchisee must pay money to a marketing or other cooperative fund, the franchisor must prepare an annual financial statement of the fund's receipts and expenses for the last financial year, including the percentage spent on production, advertising, administration and other stated expenses. The franchisor must have the statement audited by a registered company auditor within four months of the end of the financial year to which it relates. The franchisor must give to the franchisee a copy of the statement within 30 days of preparing the statement and a copy of the audit report (if applicable) within 30 days of preparing the report. The requirement for the franchise statement to be audited does not apply for a financial year if 75 per cent of the franchisees in Australia that contribute to the fund agree and such agreement is made within the period prescribed by the Code.

Franchisors have additional disclosure obligations to clarify for franchisees what, if any, arrangements exist in relation to arrangements that apply at the end of the franchise term. In addition, franchisors must give at least six months' notice of their decision to renew or not to renew a franchise agreement, or enter into a new franchise agreement. Where a franchise agreement is less than six months, the notice period is at least one month.

The disclosure document is to be updated annually within four months of the end of the financial year. However, a franchisor is required to disclose to a franchisee within a reasonable time, but not more than 14 days after the franchisor becomes aware of certain materially relevant facts, including:

- any change in majority ownership or control of the franchisor;
- any proceedings by a public agency such as the Australian Competition and Consumer Commission;
- a judgment or arbitration award in criminal or civil proceedings in Australia against the franchisor alleging:
  - breach of a franchise agreement;
  - contravention of trade practices law or the Competition and Consumer Act (CCA);
  - unconscionable conduct;
  - misconduct; or
  - an offence of dishonesty;
- a judgment against the franchisor under certain workplace relations and industrial relations laws; and
- civil proceedings in Australia against the franchisor or an associate of the franchisor by 10 per cent or 10 (whichever is the lower) of the franchisor's franchisees in Australia.

The Code provides that a franchisor cannot unreasonably withhold consent to a franchisee's request to assign a franchise agreement and curtails somewhat a franchisor's ability to terminate a franchise agreement. Immediate termination is only available in very limited circumstances, with most cases requiring a franchisee to be given written notice of default and an opportunity (of not more than 30 days) to cure the default. The Code also requires disclosure of whether the franchisor will amend the franchise agreement prior to, or on transfer of, a franchise agreement.

The Code contains a dispute resolution process that, if activated by a party, is mandatory. This may be by mediation or arbitration. The mediation process has been extremely successful in resolving disputes, with a success rate in excess of 80 per cent.

Motor vehicle dealerships

All motor vehicle dealerships are deemed franchise agreements and are therefore subject to the general provisions of the Code. There are additional provisions in the Code, mainly in relation to end of term arrangements and capital expenditure, that only apply to automotive franchise agreements. The changes made to the Code in 2020, 2021 and 2022 deal with the duration of a franchise agreement as well as return on investment, goodwill and compensation in the event of an early withdrawal from the Australian market, rationalisation of a network or changes to distribution model in Australia. Amendments to the good faith obligation now provide that a court must consider whether the terms of the franchise agreement are fair and reasonable.

Network rationalisation and changes to the distribution model are particularly relevant issues for many automotive brands in Australia as distribution options for new products, such as electric and autonomous vehicles, must be considered. Great care must be taken before entering any agreement.

Operational compliance

26 | What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

Franchise agreements typically contain extensive inspection and audit powers to enable a franchisor to ensure operational consistency and adherence to brand standards.

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

Yes, subject to having the contractual power to do so in the franchise agreement, and the obligations to act in good faith and to avoid unconscionable conduct. The Code also contains a requirement to set out in the disclosure document the circumstances in which the franchisor has unilaterally varied a franchise agreement in the past three financial years and the circumstances in which the franchise agreement may be unilaterally varied.

Policy affecting franchise relations

28 | Do other government or trade association policies affect the franchise relationship?

No.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Provided the franchisor has the contractual right to terminate in the franchise agreement, a franchisor may terminate a franchise agreement:

- for breach, provided the franchisor has given the franchisee reasonable written notice and an opportunity to remedy the breach;
- on reasonable notice where there is no breach provided the franchisor gives the reasons for termination; and
- by giving no less than seven days' notice, in special circumstances limited to:
    - the loss of any licence the franchisee needs to carry on the business;
    - insolvency;
    - company deregistration;
    - abandonment of the franchised business or the franchise relationship;
    - conviction of a serious offence;
    - business operations endangering public health or safety; and
    - fraud.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

A franchisee has a statutory right to terminate the franchise agreement under cooling-off provisions that have been significantly amended with effect as of 1 July 2021. The essence of the cooling-off arrangement is that a franchisee is entitled to terminate the franchise agreement within 14 days of entering into the agreement or making any payment under the agreement. However, the new provisions potentially link the cooling-off period to the provision of lease details or documentation and also now apply to franchisee-to-franchisee sales.

The franchisee may also provide a written proposal to terminate at any time. Although this does not give the franchisee a specific right to terminate, it does create a framework that requires careful navigation by the franchisor. The franchisor must provide a substantive written response to any proposal within 28 days, including the franchisor's reasons if the franchisor refuses to terminate on the grounds proposed. Both the franchisor and franchisee must act in good faith and a refusal to terminate on the grounds proposed may give rise to a dispute to which the alternative dispute resolution process applies.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

Franchise agreements are often drafted with a defined initial term and a further term at the franchisee's discretion. The franchisee is typically required to elect to renew in writing and the franchisor can only refuse to renew if the franchisee is in breach or fails to satisfy reasonable renewal preconditions.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Upon the expiry of the franchise agreement, a franchisee has no legal right to an extension. However, a franchisor must disclose what will happen at the end of the agreement's term in the disclosure document and must advise the franchisee of its intention in relation to any extension (typically at least six months' notice is required) prior to the end of the term. If the franchisor refuses to extend the agreement of a compliant franchisee that wishes to extend and no genuine goodwill compensation is paid to the franchisee, any non-compete provision in the franchise agreement that might otherwise restrict the franchisee at the end of the term has no effect.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes. A franchisor may withhold consent to a transfer of a franchise, if it is reasonable to do so. A franchise agreement typically sets out the conditions to be satisfied to obtain a franchisor's consent to the transfer of a franchise.

The franchisor is deemed to have consented to the transfer if it does not give or withhold its consent to a transfer within 42 days of the date of the transfer request.

The franchise agreement also typically restricts a change in ownership of the franchisee entity without the franchisor's consent.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

No. There are no restrictions on the initial upfront fees or ongoing royalties payable by a franchisee.

There are restrictions on charging franchisees for legal fees in connection with the franchise agreement, unless the fee is for the preparation of the documents at the start of the franchise and the fee is set out in the franchise agreement.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

There are no specific usury laws relating to interest payments. However, interest charged for overdue payments should reflect a genuine estimate of the loss that the non-defaulting party will incur as a result of the default and is often linked to specific state-based legislation that prescribes penalty interest rates or bank indicator lending rates plus several percentage points. Agreed provisions for the late payment of fees should also be drafted to ensure they are not rendered unenforceable as

penalties. A franchisee may challenge a late fee provision on the basis that it is an unfair term under the ACL or that the charging of an exorbitant fee is unconscionable conduct.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There are no laws that specifically restrict a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency.

If the franchisee is a financial services or gambling activity provider, or is otherwise classified as a 'reporting entity' under the Anti-Money Laundering and Counter-terrorism Financing Act 2006 (Cth), then they are required under the Act to report certain cross-border transactions to the Australian Transaction Reports and Analysis Centre.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Yes.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

In addition to the common law duty of good faith, there is now a statutory obligation for each party to a franchise agreement to act towards another party in good faith in relation to any matter arising under, or in relation to, the franchise agreement or the Code. Pecuniary penalties apply to any breach of this duty. Although the duty itself remains a common law duty, the Code explicitly applies good faith to franchise agreements and extends the application of the duty to the Code itself, as well as to the negotiation of franchise agreements and disputes. For automotive franchisors, the Code now requires a court to consider, in the context of assessing good faith, whether the terms of a franchise agreement are fair and reasonable.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

As the franchise relationship is comprehensively covered by the Code and the ACL, there is little relevance to franchisees being treated generally as consumers. Where goods or services are supplied to franchisees for consumption, as opposed to resale, the provisions of the ACL and the CCA concerning fitness for purpose and product liability can apply.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

There is no explicit requirement that the franchise agreement be in English, but the authors are not aware of a case where a franchise agreement has been made in a language other than English in Australia.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

Franchise agreements commonly contain extensive restrictions on franchisees, including in relation to:

- territorial operations;
- product sourcing;
- exclusivity of product offerings;
- product ranging and services;
- merchandising and display;
- maximum (but not minimum) pricing;
- internet selling; and
- sales and marketing.

Employee solicitation clauses are not common and governing law clauses typically choose Australian law given that conduct (which is extensively regulated) is regulated by Australian law. Foreign choice of law and jurisdiction clauses are permissible, subject to a requirement that dispute resolution must first involve mediation in Australia under the prescribed process set out in the Code.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

When franchisors, domestic or foreign, commence a dispute with a franchisee, they are required to follow the dispute resolution procedures outlined in the franchise agreement, which must provide for mediation.

Mediation is highly effective at resolving franchise disputes, but if it is unsuccessful, franchisors often initiate proceedings in the federal courts (including the Federal Circuit Court and the Federal Court), which have jurisdiction to hear matters relating to a breach of federal law (of which the Code is an example).

Franchisors can instead bring their dispute through the state or territory courts under the common law. The appropriate court may depend on the value of claims, as lower courts (including the Federal Circuit Court and the lower state and territory courts) only hear matters up to certain values. Appeals can be made from the Federal Circuit Court, and Federal Court decisions can be appealed to the Full Court of the Federal Court. Likewise, appeals from the lower state courts are heard in the supreme court of each state or territory. Appeals from either the Full Court of the Federal Court or the state's supreme court can be made to the High Court.

Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

Foreign choice of law and jurisdiction clauses are permissible, subject to a requirement that dispute resolution must first involve mediation in Australia under the prescribed process set out in the Code. Governing law clauses often choose Australian law given that conduct (which is extensively regulated) is regulated by Australian law, and Australian courts are reliable and efficient.

Arbitration – advantages for franchisors

44 What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

Arbitration is not commonly used in Australia, mainly because the Australian court system is effective and efficient, and mediation has proved to be highly successful in resolving disputes in Australian franchising. In Australia, there are very few arbitrators qualified in franchising and no particular advantages of arbitration over court litigation. Unlike in the United States, damages awards in Australia do not feature treble damages and rarely involve punitive damages. In court proceedings, it is normal for the unsuccessful party to pay the legal costs for both parties.

Most commonly, mediation is used as an alternative dispute resolution mechanism to resolve franchise disputes. Mediation must be included in dispute resolution provisions of franchise agreements and is also available under the Code. Further, federal courts are also able to order parties to undertake mediation prior to trial. Mediation is therefore frequently used and highly effective at resolving franchise disputes.

Amendments to the Code in effect as of 2 June 2021 broaden the alternative dispute resolution options to conciliation and arbitration, including binding voluntary arbitration. However, arbitration remains voluntary and franchise systems are unlikely to choose to adopt these new options.

National treatment

45 In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Foreign franchisors are not treated any differently to domestic franchisors in Australia.

UPDATE AND TRENDS

Legal and other current developments

46 Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

The Franchising Code of Conduct (the Code) was amended in April 2022.

The ease with which the Code can be amended, being by regulation rather than legislation that must pass both Houses of Parliament, means that change can occur quite quickly and with minimal public scrutiny. Australia's most recent legislative changes take the country further away from international regulatory norms and demonstrate a highly prescriptive approach to franchise sector regulation. Following the recent changes to the Code, fundamental changes to the regulatory framework are unlikely for several years.

It is expected that amendments will be made to the unfair contract terms legislation in 2022, to expand the application of those laws, as well as to broaden the types of business contracts captured within the scope of the legislation.

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MARKET OVERVIEW

Franchising in the market

1 | How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Franchising is widespread across Canada in over 50 industries including automotive, travel, senior care, education and health and fitness, the retail and restaurant sectors being the most popular. In fact, Canada has the second largest franchise industry in the world following the United States and franchising is often used by US companies to enter into the Canadian market.

As opposed to other jurisdictions, there are no registration requirements for establishing a franchise system in Canada or to obtain a licence to enter into contracts and grant franchise rights in such capacity, nor is there a requirement that disclosure documents or other materials be registered, thereby facilitating entry into franchising. Moreover, the Canadian provinces that have adopted franchise disclosure laws have rules in place governing pre-contractual disclosure only; the pre-contractual disclosure process itself is 'self-governed' in that franchisors are solely responsible for the contents of the disclosure materials and their compliance, and there is no advance submission of the disclosure items to any regulatory authorities for verification or approval.

Associations

2 | Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

Canadian franchisors and franchisees have created a robust and effective Canadian Franchise Association (CFA) to build and support the franchise industry in Canada, which currently has thousands of members nationwide. Although there is no requirement to become a member of the CFA, membership typically lends credibility to a franchise, given that franchisors are required to meet the definition of a franchise in order to qualify as members, provide proper documentation in support of their membership application, and commit to abide by the CFA Code of Ethics. Membership with the CFA also requires that franchisors use the CFA disclosure document guide and commit to giving potential franchisees all the information they need to make a viable business decision.

BUSINESS OVERVIEW

Types of vehicle

3 | What forms of business entities are relevant to the typical franchisor?

There are several different vehicles available to foreign franchisors who wish to carry on business in Canada, each with varying tax and corporate consequences. The preferred choice of vehicle used for the expansion of a foreign franchise system into Canada is the incorporation of a Canadian subsidiary. By using a Canadian subsidiary, the franchisor has a local direct physical presence and indicates to the general public that it has made a commitment to Canada. Foreign franchisors may instead wish to enter the Canadian market by franchising directly from their country without the creation of a permanent establishment in Canada, thus avoiding being considered by Canadian tax authorities as carrying on business in Canada.

Regulation of business formation

4 | What laws and agencies govern the formation of business entities?

The federal legislation under which a corporation may be incorporated is the Canada Business Corporations Act (CBCA). Provinces have also enacted similar statutes regulating the formation of corporate entities. The formation of partnerships and other non-corporate entities is governed solely by legislation that is specific to each province. Business entities must usually register with the relevant corporate or business registry of each province in which they wish to conduct business.

Requirements for forming a business

5 | Provide an overview of the requirements for forming and maintaining a business entity.

Registration mechanisms for forming and maintaining business entities in Canada are generally straightforward, requiring little more than the payment of prescribed fees and the filing of specific corporate or business registry forms that describe, inter alia, the nature of the business, its structure, the scope of its undertakings and basic information regarding its shareholders and directors. Annual filings are also typically required in each of the provinces in which a business entity carries on business and, in the case of corporations incorporated under the CBCA, at the federal level.

Restrictions on foreign investors

6 | What restrictions apply to foreign business entities and foreign investment?

Pursuant to the Investment Canada Act, foreign business entities seeking to acquire or establish a Canadian business are required to notify Innovation, Science and Economic Development Canada no later than 30 days following such acquisition or establishment. An onerous and thorough review process applies to non-World Trade Organization investors where the asset value of the acquired Canadian business is at least C$5 million for direct acquisitions or C$50 million for indirect acquisitions. However, the C$5 million threshold will apply to indirect acquisitions where the asset value of the acquired Canadian business represents greater than 50 per cent of the asset value of the global transaction. The review threshold for World Trade Organization investors was increased to an 'enterprise value' of C$1.141 billion as of February 2022. This amount is indexed annually. Most franchisors do not meet this threshold.

Furthermore, certain corporate statutes, such as the CBCA, set out requirements as to the residency of directors pursuant to which at least one director (or 25 per cent of the directors if there are more than four) must be a Canadian resident. The Canadian provinces of Manitoba and Saskatchewan also maintain certain director residency requirements for corporations. Otherwise, the corporate governance regimes of the Canadian provinces of Quebec, Ontario, British Columbia, Alberta, Nova Scotia, New Brunswick, Newfoundland and Labrador and Prince Edward Island do not have any residency requirements for directors.

Taxation

7 | What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

Generally, three business structures are available to a franchisor wishing to export its franchise system into Canada:

- A foreign franchisor may choose to contract directly with its Canadian franchisees without carrying on business in Canada directly or through a permanent establishment in Canada. In such an event, income earned in Canada by the franchisor through royalty payments and rent would be characterised as passive income and subject in Canada to a withholding tax only. The standard withholding tax rate of 25 per cent under Canadian income tax legislation is often reduced to 10 per cent by tax treaties entered into between Canada and other jurisdictions – these should be carefully reviewed and considered at the structural stage of planning any entry into the Canadian market.
- A franchisor may opt to carry on business in Canada using a Canadian branch or division. If the franchisor carries on business in Canada through a fixed place of business or permanent establishment, any income derived in respect thereof will generally qualify as 'business income' that is taxable in Canada on a net income basis. Furthermore, the income of a non-resident franchisor carrying on business through a Canadian branch will typically be subject to a 'branch tax' that is payable at the time the earnings of the subsidiary are accrued (and not at the time the income is paid to the foreign franchisor). In light of the foregoing, few franchisors choose to establish a branch office or division for the purpose of expanding into the Canadian market.
- A franchisor may choose to carry on business in Canada through a federally or provincially incorporated subsidiary. This is the most frequently used vehicle by non-resident franchisors wishing to export a franchise system into Canada. The incorporation of a subsidiary presents certain advantages, including the avoidance of Canadian withholding tax on passive income. Nonetheless, the subsidiary's income would be taxable in Canada on a net income basis and dividends paid to its parent would be subject to a withholding tax of 25 per cent. This rate is often reduced to between 5 and 15 per cent by tax treaties entered into between Canada and other jurisdictions. The franchisor may also charge a reasonable fee for providing assistance to its Canadian subsidiary in the operation of its business activities with the expectation that a reasonable portion of such fee may then be deducted from the subsidiary's income for tax purposes. Normally, a fee negotiated between arm's-length parties would meet the reasonability test.

In conclusion, significant business and tax consequences arise from each of the above-mentioned structures – a thorough review of all relevant Canadian legislation pertaining to each structure and a careful evaluation of the effect of tax treaties ratified by Canada is strongly advised.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

Each Canadian province has enacted its own health and safety, employment standards and labour relations legislation. Accordingly, provincial laws and regulations govern most matters relating to labour law (for example, minimum wages, hours of work, overtime, leave, termination of employment, union certification and collective bargaining rights).

Each franchisee must operate as a truly independent and distinct entity from its franchisor so as to be considered a separate employer for labour union certification and collective bargaining purposes. Additionally, even if the franchisee is separately incorporated and operates independently, it is imperative to ensure that there exists no common control or direction emanating from the franchisor that is greater than that which typically characterises the franchisor–franchisee relationship. To do otherwise would be to run the risk of having a union certification or collective agreement with respect to one franchisee being extended to other franchised or corporate outlets. Furthermore, most provincial jurisdictions recognise successor liability following a transfer or sale of a business, such that the new employer is bound by the union certification and, in certain circumstances, by the collective bargaining agreement concluded with the union representing the employees of the sold business.

While no provinces have enacted legislation recognising a joint employer status for franchisors *per se*, it is important to note that the Ontario Fair Workplaces, Better Jobs Act 2017, does not require that businesses carrying on associated or related activities have the intent or effect of defeating employment standards legislation in order to be treated as one employer and held jointly and severally liable, thus creating a wider scope of application and increasing the possibility of associated businesses being deemed joint employers. The Act also allowed newly certified bargaining units to consolidate with other existing bargaining units of the same employer, thereby permitting an existing collective agreement to apply to employees of more than one franchise belonging to the same franchisee. This amendment was, however, repealed by the Making Ontario open for Business Act, 2018, which came into force on 1 January 2019.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

The Trademarks Act (Canada) defines a trademark as a 'sign or combination of signs that is used or proposed to be used by a person for the purpose of distinguishing or so as to distinguish their goods or services from those of others or a certification mark'. As such, distinctiveness is

central to the definition and a trademark need not be registered to be valid, or even licensed, in Canada. Nonetheless, registration with the Canadian Intellectual Property Office has the advantage of providing nationwide protection of the registered trademark and, in the Province of Quebec, enables the use of any English-only terminology that is a registered trademark on catalogues, brochures, public signs and certain other commercial advertising (provided that no French version of the trademark has been registered and, in the case of public signage, that a generic description of the goods and services is included in French) in circumstances where the same would, as a practical matter, be prohibited absent registration. An application for registration may be filed without having to specify a basis for filing or including a declaration as to the use of the concerned trademark. Recent amendments to the Trademarks Act (Canada) have also allowed for the filing of certain non-traditional types of trademarks (such as sound, scent or taste).

Remedies available following the breach of exclusive use clauses or the use of a confusing trademark range from injunctive remedies to passing-off actions that may be instituted before either the Federal Court of Canada or the provincial superior court with territorial jurisdiction.

There is no statutory protection of know-how in Canada. Parties must rely on common law tort and contractual undertakings to protect know-how from unauthorised disclosure or use. Accordingly, the nature of the confidential information that a franchisor wishes to protect, as well as the legal consequences arising as a result of its dissemination, should be clearly identified by the contracting parties in their franchise agreement.

Canada has recently become a member country of the Madrid Protocol and therefore foreign franchisors seeking Canadian trademark registrations may apply for same by way of the Madrid International Trademark System.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

With the exception of the province of Quebec, all provincial property laws are based on the English common law system, pursuant to which real estate can either be held in fee simple or by way of a leasehold interest. Such interest is registered with the public land registry. Quebec's property laws are based on the French civil law system. They require the registration of ownership rights and permit the registration of lease rights in the public land registry.

No particular restrictions exist as to the nature of the arrangement to be concluded between the franchisor and the franchisee with regard to real (or, in civil law, immovable) property. For instance, a franchisor may wish to enter into a head lease and sublease the premises to a franchisee. In such circumstances, cross-default provisions as between the sublease and the franchise agreement are advisable so that a right to terminate for breach of one gives rise to a right to terminate the other. In the absence of such provisions, the franchise agreement and the sublease will be construed as two independent contracts and breach of one may not have any bearing on the other. Moreover, it is advisable to include automatic termination provisions in a sublease and a franchisor's right to terminate in a franchise agreement in circumstances where the head lease is terminated.

In Canada, it is more common for franchisors to lease (or require that their franchisees lease) rather than purchase real estate for franchise locations given the significant capital investment that is required and that property located in prime locations is often not available for purchase.

Generally, foreign ownership of, or the transfer to non-residents of, real estate situated in Canada is not restricted, save for those instances where such real estate benefits from statutory protection given its cultural or historical significance.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

The Competition Act sets forth penal and civil recourses with respect to various practices, including those identified as conspiracies and collusion, abuse of dominance, price maintenance, promotional allowances and price discrimination, false or misleading advertising, deceptive marketing and pyramid selling, refusal to deal, exclusive dealing, tied selling, as well as certain other vertical market restrictions.

While the penal provisions of the Competition Act impose a higher burden of proof, their violation grants injured parties the right to sue for damages caused by such practices; those damages are restricted to actual loss and costs. Fines are also applicable for certain types of offences. On the other hand, reviewable practices are civil in nature and are subject to the exclusive jurisdiction of the Competition Tribunal, upon the request of the commissioner of competition or at the request of a private party with leave from the Competition Tribunal to that effect. In the latter case, private litigants may only seek redress of conduct that constitutes a breach of an order under the Competition Act, as monetary awards are not provided for. The Competition Tribunal may make orders for a reviewable trade practice to cease or compel a business to accept a given customer or order on reasonable trade terms.

The Commissioner of Competition heads the Competition Bureau and has broad powers of investigation and inquiry, such as search and seizure, examinations under oath, and ordering the production of physical evidence or records and wiretapping (in certain circumstances). Its enquiries are conducted under strict rules of confidentiality and its powers remain subject to the supervision of the courts. On the international level, the Competition Bureau has concluded numerous agreements of notification and mutual assistance with its international counterparts and is an active member of the International Competition Network.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

The offer and sale of franchises in Canada is regulated by the provinces rather than by the federal government. Definitive franchise legislation is currently in force in six Canadian provinces: Alberta, Ontario, New Brunswick (NB), Prince Edward Island (PEI), Manitoba and British Columbia (BC). The Civil Code of Quebec also contains provisions applicable to all contracts governed by Quebec law, including franchise agreements.

The Arthur Wishart Act (Franchise Disclosure) in the Province of Ontario (the Ontario Act), the Prince Edward Island Franchises Act (PEI Act), the New Brunswick Franchises Act (the NB Act), the Manitoba Franchises Act (the Manitoba Act) and the British Columbia Franchise Act (the BC Act) each generally define a 'franchise' as a right to engage in a business where the franchisee is required to make one or several payments to the franchisor in the course of operating the business or as a condition of acquiring the franchise or commencing operations, and in which the franchisee is granted either:

- the right to sell goods or services substantially associated with the franchisor's trademarks in circumstances where the franchisor or any of its associates has significant control over, or offers significant assistance in, the franchisee's method of operation; or

- representational or distribution rights to sell goods or services supplied by the franchisor or its designated supplier, and the franchisor (or any person it designates) provides location assistance to the franchisee.

Under the Ontario Act, the definition of 'franchise' provides that the right to exercise control over the franchisee's method of operation, as opposed to the actual exercise of that control, may be sufficient for the purposes of characterising a business as a franchise, which definition potentially increases the number of business relationships that may fall under the Ontario Act's application.

The Ontario Act, the PEI Act, the NB Act and the BC Act apply to franchise agreements entered into on or after 1 July 2000, 1 July 2006, 1 February 2011 and February 1 2017, respectively, and to renewals or extensions of franchise agreements, regardless of whether such franchise agreements were entered into before or after such date, provided that the business operated pursuant to such franchise agreements is to be operated partly or entirely in Ontario, PEI, NB or BC, respectively. The Manitoba Act is conceptually similar and applies to franchise agreements entered into, renewed or extended on or after 1 October 2012. Furthermore, there is no residency requirement in respect of the franchisee with respect to whom the Ontario Act, the PEI Act, the NB Act, the Manitoba Act or the BC Act applies.

In Alberta's Franchises Act (the Alberta Act), a 'franchise' is defined as a right to engage in a business:

- in which goods or services are sold, offered for sale or distributed under a marketing or business plan substantially prescribed by the franchisor or any of its associates and that is substantially associated with any of its trademarks, service marks, trade names, logotypes or advertising; and
- that involves a continuing financial obligation of the franchisee to the franchisor or any of its associates and significant continuing operational controls by the latter on the operation of the franchised business, or the payment of any franchise fee (the latter fee being defined as any direct or indirect payment to purchase or to operate a franchise), and includes a master franchise and subfranchise.

The Alberta Act applies to the sale of a franchise made on or after 1 November 1995 if the franchised business is to be operated partly or entirely in Alberta and if the purchaser of the franchise is an Alberta resident or has a permanent establishment in Alberta for the purposes of the Alberta Corporate Tax Act.

Given the breadth of these definitions, Canadian franchise legislation may cover a number of business agreements and traditional distribution or licensing networks that would not typically qualify as franchise agreements, as the term 'franchise agreement' may be understood in other jurisdictions.

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

Currently adopted franchise legislation is limited to the Alberta Act, the Ontario Act, the PEI Act, the NB Act, the Manitoba Act and the BC Act (collectively, the Canadian Franchise Acts). No other province or territory of Canada has regulated the offer and sale of franchises through franchise-specific legislation.

Exemptions exist in each of the Canadian Franchise Acts, other than the Alberta Act, as follows.

Full exemptions

The Canadian Franchise Acts, other than the Alberta Act, do not apply to the following commercial relationships:

- employer–employee relationships;
- partnerships;
- memberships in a cooperative association, as prescribed in the NB Act, the PEI Act, the BC Act or the regulations to the Ontario Act, as the case may be;
- arrangements for the use of a trademark, trade name or advertising to distinguish a paid-for evaluation, testing or certification service for goods, commodities or services;
- arrangements with a single licensee in respect of a specific trademark, trade name or advertising if it is the only one of its general nature and type to be granted in Canada;
- any lease, licence or similar agreement for space in the premises of another retailer where the lessee is not required or advised to buy the goods or services it sells from the retailer or any of its affiliates (Ontario Act only);
- oral relationships or arrangements without any writing evidencing any material term or aspect of the relationship or arrangement;
- a service contract or franchise-like arrangement with the Crown or an agent of the Crown (except the Manitoba Act and the BC Act); and
- an arrangement arising out of an agreement for the purchase and sale of a reasonable amount of goods at a reasonable wholesale price or for the purchase of a reasonable amount of services at a reasonable price (except the Ontario Act).

Partial exemptions – the obligation to disclose

All of the Canadian Franchise Acts, other than the Alberta Act, contain exemptions from disclosure requirements that include, for example, the sale of a franchise to a person to sell goods or services within a business in which that person has an interest, provided that the sales arising from those goods or services do not exceed 20 per cent of the total sales of the business during the first year of operation of the franchise.

Exemptions are also set out in the Canadian Franchise Acts, other than the Ontario Act and the BC Act, in connection with the granting of a franchise if the prospective franchisee is required to make a total annual investment to acquire and operate the franchise in an amount that does not exceed the amount prescribed under each of the Canadian Franchise Acts, currently C$5,000. Under the Ontario Act, an exemption similar to the foregoing exists in connection with the granting of a franchise if the prospective franchisee is required to make a total initial investment (not a total annual investment), determined in the prescribed manner, of an amount that does not exceed a prescribed amount, currently C$15,000.

Exemptions exist in the Ontario Act, the Alberta Act and the BC Act with respect to the obligation to provide a disclosure document as follows:

- sale of a franchise by a franchisee provided that:
  - the franchisee is not the franchisor or an associate, director, officer or employee of the franchisor;
  - the sale is for the franchisee's own account;
  - the sale is not effected by or through the franchisor; and
  - in the case of a master franchise, the entire franchise is sold;
- sale of a franchise to a person who has been an officer or director of the franchisor or its associate for at least six months for that person's own account (Alberta Act and BC Act only);
- the sale of a franchise to a person for the person's own account or to a corporation that the person controls if the person (1) has been an officer or director of the franchisor or of the franchisor's associate for at least six months and is currently such an officer or director; or (2) was an officer or director of the franchisor or of the franchisor's associate for at least six months and no more than four months have passed since the person was such an officer or director (Ontario Act only);

- sale of an additional franchise to an existing franchisee if the additional franchise is substantially the same as the franchise that the franchisee is operating;
- a renewal or extension of an existing franchise agreement;
- the grant of a franchise for one year or less and that does not involve payment of a non-refundable franchise fee (Ontario Act and BC Act only);
- sale of a franchise by an executor, administrator, sheriff, receiver, trustee, trustee in bankruptcy or guardian on behalf of a person other than the franchisor or the estate of the franchisor;
- the grant of a franchise if the franchisor is considered to be operating or participating in a multi-level marketing plan pursuant to the Competition Act (Canada) (Ontario Act and BC Act only);
- sale of a right to a person to sell goods or services within or adjacent to a retail establishment as a department or division of the establishment, if the person is not required to purchase goods or services from the operator or the retail establishment (Alberta Act only); and
- sale of a fractional franchise (Alberta Act only).

The exemptions set out in each of the Canadian Franchise Acts, while substantively similar, are not identical. Under the BC Act, the sale of a franchise to a franchisee who invests more than a prescribed amount (currently C$5 million) in the acquisition and operation of the franchise is exempted from the application of the disclosure requirements. Under the Ontario Act, the sale of a franchise if the prospective franchisee is required to make a total initial investment, determined in the prescribed manner, of an amount that is greater than a prescribed amount, currently C$3 million, is exempted from the application of the disclosure requirements.

One does not have to comply with the disclosure requirements under the Alberta Act when granting a licence to a person to sell goods or services within or adjacent to a retail establishment as a department or division of said establishment without requiring that the person purchase goods or services from the operator of the retail establishment.

Under the Manitoba Act and the BC Act, a franchisor is not required to provide financial statements to a franchisee if the franchisor meets certain criteria, including:

- a net worth of at least C$5 million or, alternatively, having a net worth of at least C$1 million to the extent that the franchisor is controlled by a corporation whose net worth is at least C$5 million; and
- the existence of at least 25 of its franchisees engaged in business in Canada at all times during the five-year period preceding the date of the disclosure document.

In addition, each of the Canadian Franchise Acts other than the Alberta Act and the BC Act affirms that a franchisor may apply for a ministerial exemption allowing it not to include its financial statements in a disclosure document.

Principal requirements

14 What are the principal requirements governing the offer and sale of franchises under the relevant laws?

There are no specific requirements governing the offer and sale of franchises under the Canadian Franchise Acts, other than the requirements of pre-contractual disclosure. In Quebec, article 1375 of the Civil Code of Quebec establishes a duty of the parties to conduct themselves in good faith, which duty extends to pre-contractual negotiations. This obligation has generally been interpreted to require that franchisors inform franchisees during the offer and sale stage of franchises of any information that could affect their decision to enter into the franchise agreement and, correspondingly, that franchisees inform themselves through reasonable due diligence and investigation prior to entering into the franchise agreement.

Franchisor eligibility

15 Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

Except for compliance with applicable Canadian Franchise Acts and other legislation, there is no requirement – for example, that a franchisor be in business for a minimum period, that a franchisor has operated a minimum number of franchisor-owned operations, or that a franchisor has operated in Canada with franchisor-owned operations for a minimum period – that must be met before a franchisor may offer franchises.

Franchisee and supplier selection

16 Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

There are no generally applicable restrictions governing the recruitment and selection of franchisees or franchisee's suppliers, the locations of franchised outlets or the distance between outlets. However, such restrictions do exist in certain industries whose products or services are specifically regulated, such as the tobacco industry, the alcohol industry and the cannabis industry. For practical purposes, it is generally advised to consider a potential franchisee's aptitudes, character traits, financial wherewithal and experience as an independent businessperson and a supplier's experience in the relevant industry and its knowledge of the market and the territory, when evaluating whether to enter into a long-term relationship with such potential franchisee or supplier, respectively.

Pre-contractual disclosure – procedures and formalities

17 What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

A franchisor governed by any of the Canadian Franchise Acts must furnish a prospective franchisee with a disclosure document not less than 14 days before the earlier of the signing by the prospective franchisee of the franchise agreement or any other agreement relating to the franchise, or the payment of any consideration by or on behalf of the prospective franchisee to the franchisor or any of its associates relating thereto.

All of the Canadian Franchise Acts exclude confidentiality and site selection agreements from the definition of franchise agreements for the application of the disclosure requirements. In addition, the Alberta Act, the BC Act, the Manitoba Act and the Ontario Act also exempt agreements that only contain terms and conditions relating to a fully refundable deposit (that is, a deposit that does not exceed 20 per cent of the initial franchise fee (capped at C$100,000 under the Manitoba Act and the Ontario Act) and is refundable without any deductions or any binding undertaking of the prospective franchisee to enter into any franchise agreement).

A franchisor must also furnish a prospective franchisee under each of the Canadian Franchise Acts with a description of any 'material

change' as soon as practicable after the change has occurred and prior to the earlier of the signing of any agreement or the payment of any consideration by the prospective franchisee in relation to the franchise. A 'material change' is defined as a change (even if not yet implemented in certain cases) in the business, operations, capital or control of the franchisor or any of its associates, or in the franchise system, which change would reasonably be expected to have a significant adverse effect on the value or price of, or on the decision to acquire, the franchise.

Pre-contractual disclosure – content

18 What information is the disclosure document required or advised to contain?

The regulations under each of the Canadian Franchise Acts require that general information concerning the franchisor be included in the relevant disclosure document. This information includes the history of the franchisor, the business background of its directors, the general partners and the officers of the franchisor, and whether any of those persons has been subject to bankruptcy or insolvency proceedings or has been previously convicted of fraud or unfair or deceptive business practices. While substantively similar, the list of information that must be disclosed under each of the Canadian Franchise Acts is not identical.

Financial statements must be included in the disclosure document governed by the Canadian Franchise Acts, although the requirements set out in the regulations adopted under the Alberta Act (Alberta Regulations) differ substantially from those adopted under the other Canadian Franchise Acts. For instance, the latter regulations compel the inclusion in each disclosure document of statements regarding initial 'risk factors', whereas those are not required under the Alberta Regulations. The regulations adopted under the BC Act (BC Regulations) also differ from those adopted under the other Canadian Franchise Acts as they require franchisors having operated for less than one fiscal year to disclose an opening balance sheet, prepared in the same manner as financial statements.

The disclosure document must also include all 'material facts'. This encompasses any information about the business, operations, capital or control of the franchisor, its associates or the franchise system that would reasonably be expected to have a significant effect on the decision to acquire or the value of the franchise. Unlike all of the other Canadian Franchise Acts, the BC Act does not require franchisors to disclose how they select franchise locations, unless this information is considered a 'material fact' that would otherwise be subject to disclosure. The BC Act also provides that franchisors must provide potential franchisees with a list of all current franchises in Canada and not only those located in BC.

Pre-sale disclosure to sub-franchisees

19 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Each of the Canadian Franchise Acts imposes the obligation to disclose upon 'franchisors', the definition of which includes a sub-franchisor with regard to its relationship with a sub-franchisee. Accordingly, presale disclosures must be made to a sub-franchisee by the sub-franchisor in accordance with the same procedural and substantive requirements, and exemptions pertaining thereto, that apply to franchisors with regard to their relationships with their franchisees. Moreover, information regarding a sub-franchisor's relationship with the franchisor must be disclosed to a prospective sub-franchisee, but only to the extent that such information constitutes a material fact or is necessary for the sub-franchisor to properly acquit itself of its duty to furnish the information expressly prescribed by the relevant statutory and regulatory provisions governing disclosure.

Due diligence

20 What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

While the scope of proper due diligence efforts is too broad to be addressed in a short response, we would include at the core of such efforts: (1) from a franchisee's perspective, conducting proper due diligence on the business opportunity being offered including evaluating its financial return, meeting with already established franchisees in the franchise system and building a business plan; and (2) from a franchisor's perspective, it will be important to evaluate the financial wherewithal of the prospective franchisee and whether its representatives have sufficient experience in the industry to successfully operate a franchise location and a fulsome grasp of the vision and philosophy of the franchised concept so as to be an effective operator and representative of the brand. In addition, with respect to franchisees establishing the first Canadian franchise location of an existing foreign franchise system in Canada, it will be important for franchisees to evaluate whether the franchisor has adapted its franchise system to the Canadian market to comply with certain local requirements, for example, whether the franchisor has translated its materials and website to French for franchisees located in the province of Quebec.

Failure to disclose – enforcement and remedies

21 What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

Under each of the Canadian Franchise Acts, an action for damages or rescission may be instituted by the franchisee for non-compliance. The NB Act provides that a party to a franchise agreement may, in the event of a dispute with another party to such agreement, trigger a mandatory alternative dispute resolution mechanism (mediation). The foregoing does not, however, preclude any party to such franchise agreement from availing itself of other recourses available under contract or at law.

Rescission

Pursuant to all Canadian Franchise Acts, other than the Alberta Act, a franchisee may rescind the franchise agreement without penalty or obligation: 'for late disclosure', no later than 60 days after receiving the disclosure document if the franchisor failed to provide said document or a statement of material change within the prescribed time or if the contents of the disclosure document do not satisfy statutory requirements; or 'for absence of disclosure', no later than two years after entering into the franchise agreement. In either case, within 60 days of the effective date of rescission the franchisor must:

- purchase from the franchisee any remaining inventory, supplies and equipment purchased pursuant to the franchise agreement, at a price equal to the purchase price paid by the franchisee, and refund any other money paid by the franchisee; and
- compensate the franchisee for the difference between any losses incurred in acquiring, setting up and operating the franchise, and any amounts paid or refunded pursuant to the preceding paragraph.

Should a franchisor fail to provide the disclosure document as required under the Alberta Act, the prospective franchisee is entitled to rescind the franchise agreement by giving a cancellation notice to the franchisor or its associate, as the case may be, no later than the earlier of 60 days

after receiving the disclosure document or two years after the grant of the franchise.

The franchisor does not have an obligation to purchase any of the franchisee's assets under the Alberta Act but must instead, within 30 days after receiving a cancellation notice, compensate the franchisee for any net losses incurred by the latter in acquiring, setting up and operating the franchised business.

Damages

Pursuant to all Canadian Franchise Acts, other than the Alberta Act, if a franchisee suffers a loss because of a misrepresentation contained in the disclosure document or in a statement of material change or as a result of the franchisor's failure to comply with any disclosure requirements, the franchisee has a right of action for damages against the franchisor, the franchisor's broker (if any), the franchisor's associates, every person who signed the disclosure document or statement of material change and, under the Ontario Act, the franchisor's agent, all of whom are jointly and severally liable.

Under the Alberta Act, a franchisee who suffers a loss resulting from a misrepresentation contained in a disclosure document has a right of action for damages against the franchisor and every person who signed the disclosure document, on a joint and several basis.

Failure to disclose – apportionment of liability

22 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Liability is imposed on franchisors and sub-franchisors for misrepresentations contained in a disclosure document, although the extent and scope of such liability is contingent upon the applicable franchise legislation. Where a franchisor and a sub-franchisor are found liable for misrepresentations contained in a disclosure document, their liability will be of a joint and several nature.

Generally, the officers, directors and employees of a company cannot be sued in their personal capacity for the debts and obligations of the company. Accordingly, a key advantage presented by the subsidiary structure is the creation of a generally effective shield for the foreign franchisor seeking to avoid exposure to liabilities arising in Canada. Nevertheless, liability will not be entirely absorbed by the corporate subsidiary in those cases where a separate entity furnished a guarantee under the franchise agreement or breached its legal or statutory obligations in regards to the same.

The Canadian Franchise Acts extend liability for misrepresentations contained in a disclosure document to a much broader class of persons than those who would otherwise be liable under Canadian common law. Under the Alberta Act, a franchisee has a right of action not only against the franchisor, but also against every person who signed the misrepresentative disclosure document. Similarly, each of the other Canadian Franchise Acts provide that a franchisee may not only claim damages for misrepresentation from the franchisor, but also from the broker and associate of the franchisor as well as every person who signed the relevant disclosure document or statement of material change. In light of the very broad statutory construction given to the term 'franchisor's associate', the principal owner or controlling shareholders of a franchisor who are personally involved in the granting or marketing of the franchise may qualify as franchisor's associates. Similarly, parent companies of Canadian subsidiaries incorporated for the purpose of conducting franchise operations in Canada may also qualify as franchisor's associates where such parent companies participate in the review or approval of the granting of a franchise.

General legal principles and codes of conduct

23 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

General principles of law that may affect the offer and sale of franchises vary depending on the province in which a franchisor wishes to grant franchises.

In all provinces of Canada other than Quebec, general common-law principles regarding contract formation govern the offer and sale of franchises. In Quebec, franchise agreements are governed by the general principles of contract formation found in the Civil Code of Quebec and are generally regarded as contracts of adhesion. The Civil Code of Quebec, in an effort to correct a presumed economic imbalance between the parties, provides more favourable interpretation principles and a significantly broader margin of redress for the adhering party to a contract of adhesion than that which would be available absent a contract of adhesion. Furthermore, an abusive clause in a contract of adhesion will be considered null, or the obligation arising from it may be reduced by a court.

In addition, courts in Quebec have established that franchisors must inform potential franchisees of any information in their possession that may have a decisive influence on the franchisee's will to contract. While franchising practitioners in Quebec have generally viewed this disclosure obligation as essentially similar to the obligation of franchisors under the Canadian Franchise Acts to disclose all 'material facts' to the franchisee, Quebec courts may give it a broader interpretation – courts have found a franchisor liable for failing to disclose to the potential franchisee internal reports and documents commissioned and produced upon the franchisor's request and at its expense, such as feasibility studies in respect of potential locations and aptitude tests with respect to the potential franchisee.

Fraudulent sale

24 What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

The rights conferred by each of the Canadian Franchise Acts are in addition to, and do not derogate from, any other right, remedy or recourse that a franchisee may have in law.

Judicial decisions emanating from the common law provinces reflect a general and growing affirmation of the common law duty of good faith in franchising, the substantive requirements of which will be conditioned by the specific set of circumstances surrounding the formation of the franchise agreement and the conduct of both parties. Where the courts find that there has been a breach of such duty of good faith, the franchisor may be found liable to the franchisee for its damages. Not every breach of such duty will constitute a fundamental breach of the franchise agreement, which fundamental breach would excuse the franchisee from future performance under the agreement.

In addition, pursuant to article 1401 of the Civil Code of Quebec, an error by a party induced by a fraud committed by the other party, or with its knowledge, will nullify consent whenever, but for the error, the misled party would not have contracted or would have contracted on different terms. It is important to note that in Quebec silence may amount to a misrepresentation. Such a fraud could be sanctioned with damages and annulment of the contract or, should the franchisee prefer to maintain the contract, a reduction of its obligations set out in the franchise agreement equivalent to the damages to which it would otherwise be entitled.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

Other than the Canadian Franchise Acts, there are no specific statutes directly affecting the franchise relationship. With respect to matters not governed by the Canadian Franchise Acts, the ongoing franchise relationship is subject to generally applicable federal and provincial statutes and the principles of contractual law that emanate from the civil law in Quebec or the common law everywhere else in Canada.

Canadian courts have been pragmatic in their approach to ongoing relational matters as they relate to franchising. The clear and express terms of a franchise agreement will be determinative of the issues arising in connection with same. If such agreements are ambiguous on a given point, courts will generally construct the litigious terms in a manner that provides for a 'sensible commercial result'. This has not, however, prevented courts from rendering judgments against franchisors that excessively and unlawfully interfere with the economic interest of their franchisees.

Operational compliance

26 What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

Franchise agreements will often contain several controls and oversight mechanisms in favour of the franchisor to verify the accuracy of royalty payments made, supervise the use of its marks and ensure overall compliance of the franchised operations with the franchised concept and the brand. These may include an obligation for the franchisee to submit weekly, monthly or annual reports of its sales, or both, in addition to point of sale, inventory control and other software that report in real time. The franchisor may also have a right to inspect and audit franchisee's records in the event that a franchisee fails to submit these reports or these reports are suspected or determined to be inaccurate. Other controls include requiring that franchisees submit all proposed store locations, store designers and contractors, product suppliers and marketing materials to franchisor for prior approval, as well as a right to inspect the franchise location during operating hours to ensure that the franchisee is properly implementing the franchise system, including rights to assume management of the franchised location in extreme cases.

Amendment of operational terms

27 May the franchisor unilaterally change operational terms and standards during the franchise relationship?

To maintain competitiveness in the market, franchisors must continuously change and evolve their franchise systems to adapt to market realities. While franchisors may reserve the right to modify the franchise system throughout the term of the franchise agreement, the implementation of substantial operational standards may be difficult if not all franchisees are in agreement with the change or this change imposes a significant financial burden on franchisees. On the other hand, in the Province of Quebec a franchisor may be liable if it fails to implement necessary changes to maintain the competitiveness and relevance of the franchise system, resulting in a significant erosion of the franchise network's market share. Franchisors should, therefore, be mindful of its franchisee's interests when implementing any operational changes to avoid potential objections, whether business or legal, from a large group of franchisees in the network.

Policy affecting franchise relations

28 Do other government or trade association policies affect the franchise relationship?

No other government policies or requirements directly affect the franchise relationship.

Termination by franchisor

29 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

There are no restrictions at law on the parties' rights to contractually establish termination rights and consequences arising upon termination. Nevertheless, courts may require that a material breach of the agreement be proven to permit its termination and will, from time to time, intervene to redress cases of abuse.

Termination by franchisee

30 In what circumstances may a franchisee terminate a franchise relationship?

There are no rights at law that would specifically allow a franchisee to terminate the franchise relationship other than those applicable to all contracts under general principles of law and those expressly granted by the Canadian Franchise Acts. Similarly, there is no restriction precluding the parties from granting specific termination rights to a franchisee, although this is not often seen in typical franchise agreements used in Canada.

Renewal

31 How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

The requirements to renew a franchise agreement are not prescribed by law. As such, the franchisor and franchisee will be free to determine the conditions incumbent upon the franchisee's exercise of a right to renew the franchise agreement. These conditions generally include requirements to provide written notice of the franchisee's intention to exercise the renewal right within a specific period of time, to make certain capital expenditures to modernise its franchise location to reflect the then current image of the brand, to be in compliance with the terms of the franchise agreement and to pay a franchise renewal fee. The right to renew may also be conditioned upon the execution of an updated version of the franchise agreement. While a franchise agreement may provide for automatic renewal, it is more common for renewal to be subject to substantive requirements similar to those described herein.

Refusal to renew

32 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

In Canada, a franchisor may refuse to renew a franchise agreement with its franchisee unless such renewal is contractually required. The franchisor may contractually subject such renewal to the signature by the franchisee of a new franchise agreement and other conditions, including performance goals that the franchisee is required to achieve.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

A franchisor may contractually restrict a franchisee's ability to transfer its rights and interests under the franchise agreement, most notably by subjecting such transfer to the prior consent of the franchisor.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

No general restrictions apply to payment of initial fees. Where franchises are involved in the sale of specifically regulated products or services, including liquor, medical or pharmaceutical products and services, however, a franchisor's ability to collect royalties on such sales may be restricted.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

Franchise agreements frequently set out the rates of interest charged on overdue fees and royalty payments. Section 347 of the Criminal Code (Canada) provides that anyone who enters into an agreement to receive interest, or who receives a payment or partial payment of interest, at an effective annual rate of interest (broadly defined) in excess of 60 per cent on the credit advanced, commits an offence thereunder.

In addition, section 4 of the Interest Act (Canada) specifies that unless the contract expresses the applicable rate of interest on an annualised basis, interest will only be recoverable at a rate of 5 per cent per annum despite the terms of the contract.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

A franchisee may be required to make payments in a foreign franchisor's domestic currency. Nevertheless, the Currency Act (Canada) precludes a Canadian court from rendering a judgment in any currency other than Canadian currency.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are not only enforceable but highly advisable in light of the fact that recourse is only otherwise available under common law tort, as opposed to under any specific Canadian statute governing trade secrets or other confidential information. Confidentiality clauses can be for a longer duration than noncompete clauses.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

The Canadian Franchise Acts impose a general obligation of fair dealing upon the parties to a franchise relationship. It is established law in Canada that the relationship between a franchisor and a franchisee is generally not a fiduciary one.

The Supreme Court of Canada has found that there is an inherent duty for parties to honestly perform their contractual obligations, which precludes a contracting party from actively deceiving or knowingly misleading its contractual counterparty, including by way of lies, half-truths, omissions and even silence, depending on the circumstances.

Canadian courts (even in provinces without franchise legislation) have also generally begun to read into franchise agreements an implied duty of simple good faith (as opposed to 'utmost good faith'). A perhaps more fulsome obligation exists under the Civil Code of Quebec, which imposes a legal requirement for all parties in matters governed by Quebec civil law to conduct themselves in good faith during contractual and pre-contractual dealings. Accordingly, the courts have stated that where the franchisor retains sole discretion to authorise, prevent or proceed with a particular course of action, the franchisor will have to exercise its discretion reasonably. In addition, the duty to act in good faith requires a prompt response to another party's request and the making of a decision within a reasonable period of time thereafter. Moreover, parties under a duty of good faith must also pay any amounts that are clearly owed to another party in a timely manner.

The duty to act in good faith does not necessarily preclude a franchisor from competing with its franchisee (assuming, of course, the absence of contractual exclusivity in favour of the franchisee). A franchisor that opts to compete with its franchisee must ensure that it continues to perform its legal obligations towards the latter and that it acts in such a way that the franchisee may continue to enjoy the benefits of its franchise. The common law principle of non-interference with the freedom of the parties to contract will often limit judicial interference in franchise agreements whose terms are found to accurately reflect the intent of the parties and are not patently inequitable. A determination as to whether a duty of good faith has been breached will be contingent upon all of the surrounding circumstances.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

Consumer protection legislation in Canada has been enacted at the provincial level. The applicability of such legislation is generally restricted to transactions entered into for personal, family or household purposes and the legislation generally excludes from its ambit transactions entered into for business purposes. In a 2004 case before the Superior Court of Quebec, a franchisee sought to avail itself of protection under the Consumer Protection Act (Quebec) but was unsuccessful, the Court concluding that the tenor of the correspondence between the franchisee and the franchisor, as well as the nature of the franchise agreement, both clearly implied a commercial relationship falling outside of the scope of the legislation.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

The Charter of the French Language (Quebec) compels businesses to prepare franchise agreements and disclosure documents in French for use in the Province of Quebec unless the parties have expressly agreed that another language may be used, which is not uncommon in circumstances where both parties are comfortable in such other language.

Restrictions on franchisees

41 What types of restrictions are commonly placed on the franchisees in franchise contracts?

Franchise agreements often provide for exclusive territories and exclusive dealings with designated suppliers. These are not illegal *per se*, but are subject to competition law concerns relating to substantial lessening of competition and market barriers, including the exclusive dealings and abuse of dominance provisions of the Competition Act (Canada). Restrictions on the customers that the franchisee is entitled to serve may not be acceptable as they may be viewed as violating the market division prohibitions of the Competition Act or providing strong evidence of collusion pursuant to the same. These business practices are only subject to review if they have a negative impact on competition in the concerned market, which would typically only arise if a franchisor or its network has a considerable market share.

Price maintenance is a reviewable trade practice under the Competition Act. The threshold for enforcement authorities to apply sanctions on the basis of price maintenance requires that the franchisor's conduct be likely to have an adverse effect on competition. Providing a minimum resale price or advertised price may be considered evidence of undue influence by the franchisor and invite review by the Competition Bureau; however, franchisors may impose maximum prices as long as the latter are clearly referred to and defined in the franchise agreement and are not construed by courts as demonstrating an intent to establish a minimum resale price. Accordingly, it is always prudent for franchisors to include disclaimers, whether in advertising or on packaging, to the effect that franchisees are at liberty to establish their own resale prices. Furthermore, it is preferable to contractually provide that prices are only suggested and that the failure of the franchisee to adhere to the suggested prices will not result in termination of the franchise agreement or detrimentally affect the relations between the parties.

Franchisors who are deemed to control a market are also subject to review by the Competition Bureau under the abuse of dominance provisions in the Competition Act. As of 2009, the criminal pricing provisions addressing price discrimination, predatory pricing, geographical price discrimination and promotional allowances have been repealed with a view to promoting innovative pricing programmes and increasing certainty for Canadian businesses. Nonetheless, such pricing policies may be reviewed under civil provisions of the Competition Act where there is evidence of a likely substantial anticompetitive effect.

Non-competition and non-solicitation covenants are closely monitored by the courts. All restrictive covenants raise restraint of trade concerns and, accordingly, only reasonable restrictions as to scope of action (described with sufficient particulars), duration and geographical reach will be upheld by the courts. Canadian courts will generally not write down or reduce restrictive covenants determined to be unreasonable but will uphold or strike down the covenant in its entirety.

Last, all Canadian provinces permit the selection of a foreign governing law as long as doing so is not considered to be in fraud of the domestic law. That said, Canada is party to numerous international treaties such as the Vienna Convention on the International Sale of Goods – where the selected or applicable law is that of Canada, the foregoing Convention finds automatic application unless expressly set aside by the parties in their contract.

Courts and dispute resolution

42 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The Constitution Act, 1867 sets out the areas of law with respect to which the federal government has the power to legislate (for example, intellectual property, bankruptcy, trade and commerce) and the areas of law with respect to which each provincial government has the power to legislate within provincial borders (eg, property and civil rights). Canada also has a dual court system. The Federal Court of Canada has jurisdiction over matters in respect of which jurisdiction as to subject matter is specifically conferred to it by statute, whereas the provincial courts have residual jurisdiction over remaining matters.

Choice of forum clauses are generally enforced by the Canadian courts, thus making it possible for the parties to choose that a non-Canadian court resolve any dispute or claim arising from any agreement. In addition, mediation and arbitration are viable and recognised mechanisms of dispute resolution across Canada. Furthermore, Canada is a signatory party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Both the federal and the provincial governments have also adopted substantially similar legislation to the UNCITRAL Arbitration Model Law. To date, four provinces (Ontario, British Columbia, Alberta and Saskatchewan) have incorporated mandatory alternative dispute resolution processes into their respective procedural statutes, and most provinces have enacted arbitration legislation. In addition, the revised Quebec Code of Civil Procedure, which came into force on 1 January 2016, requires parties to consider private dispute prevention and resolution methods before referring their dispute to the courts.

Governing law

43 Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

Under the Canadian Franchise Acts, a choice of law provision which attempts to contractually restrict the application of local franchise laws will be void. Where the Canadian Franchise Acts do not apply, Canadian courts will generally recognise and uphold a parties' choice of foreign governing law, provided that there is a sufficient nexus to the parties' relationship. However, a choice of foreign governing law made with a view of avoiding the consequences of the applicable provincial laws of any Canadian jurisdiction will generally be considered invalid. Furthermore, where the applicable law is that of any province in Canada, the Vienna Convention on the International Sale of Goods will automatically apply in respect of sales of goods by foreign franchisors who are nationals of any other signatory nation, unless expressly set aside by the parties in the contract. Enforcement of a contract in any province of Canada governed by the law of another province of Canada (or another country) may also prove to be cumbersome from a practical perspective as experts of the governing law in question must be retained to provide evidence of the relevant provisions of such foreign law in court.

Arbitration – advantages for franchisors

44 What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

The principal advantages and disadvantages of arbitration for foreign franchisors in Canada are essentially the same as for local franchisors.

Arbitration has the main advantage of being confidential. Disputes between franchisors and franchisees do not become a matter of public record as would be the case with litigation in the judicial system. In addition, arbitration gives the parties a level of control that they may not otherwise have over some aspects of the dispute, such as choice of venue and forum and the selection of an arbitrator with expertise in franchise issues or the relevant technical or specialised fields.

Arbitration agreements are final, reliable and not open to appeal; Canadian courts have generally refrained from intervening in such decisions. Finally, arbitration tends to be faster and cheaper than litigation, at least in theory.

As for its disadvantages, arbitration, like litigation, can become bogged down procedurally, diminishing the cost and time savings that often motivate its use. The lack of ability to appeal heightens risk for the parties that have no recourse against a bad decision. Some also argue that arbitration clauses that preclude access to the judicial system will prevent the use of proceedings such as injunctive or other equitable relief that can be obtained quickly to effectively end a breach of contract.

Another form of alternative dispute resolution favoured in Canada is mediation, which allows the parties to discuss between themselves, usually with the aid of an impartial and respected mediator, to arrive at a resolution of the dispute on mutually acceptable terms. Mediation is often provided in agreements as a dispute resolution procedure through which parties must first attempt to resolve their dispute, failing which they can resort to arbitration.

National treatment

45 | In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

There is no legal discrimination or heightened level of legal requirements for foreign franchisors. Nevertheless, depending on the vehicle they choose through which to export their franchises to Canada, foreign franchisors may find themselves subject to a different taxation regime from domestic franchisors, and subject to certain notice requirements under the Investment Canada Act. As a practical matter, franchisees may be more hesitant to enter into a franchise agreement, particularly one where the obligations of the franchisor (for example, training, advertising) are numerous, in circumstances where the franchisor has no domestic presence of note.

UPDATE AND TRENDS

Legal and other current developments

46 | Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

The Province of Quebec in Canada has enacted significant legislative amendments to the Quebec Act respecting the protection of personal information in the private sector through the gradual implementation of Bill 64, an Act to modernise legislative provisions as regards the protection of personal information (Bill 64). The key changes implemented by Bill 64 include the following obligations:

- the appointment (by default) of the person exercising the highest authority within an organisation (ie, the CEO) as privacy officer, with power to delegate to another the responsibilities associated with the privacy office;
- the imposition of stringent breach reporting obligations;
- the preparation of privacy impact assessments prior to communicating personal information of Quebec residents anywhere outside the Province of Quebec, including elsewhere in Canada (and the obligation to refrain from doing so in the event that the findings of such privacy impact assessments reveal a failure to meet the standards imposed by law); and
- the conclusion of written agreements with outsourcers or services providers containing statutorily provided protections.

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In implementing Bill 64, the Quebec legislature is further curtailing the effects of invasive methods used by business entities such as franchisors to collect, hold, use and share personal information by (1) heightening consent requirements, (2) imposing robust accountability measures, (3) levying significant penalties for non-compliance, (4) granting greater oversight to the *Commission d'accès à l'information* (the Quebec Privacy Commission) and (5) granting private rights of action for individuals.

To ensure timely compliance with the new regulatory obligations introduced by Bill 64, franchisors currently conducting or otherwise wishing to conduct business in the Province of Quebec should seek guidance from specialised counsel so as to evaluate and understand the impacts of the foregoing on the privacy practices to be implemented within their franchise network.

China

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Franchising as a business model is developing rapidly in China. The first pilot franchise regulations in the People's Republic of China (PRC) were adopted in 1997. Since then, domestic franchises have taken off, particularly as Chinese consumers gained more purchasing power. At the end of 2020, the top 100 franchise systems in China operated more than 299,000 franchise units – 16 per cent more than the 2019 figure.

Western brands are often viewed favourably by Chinese consumers, as they are associated with high quality and superior customer service. Before the covid-19 pandemic, the sectors where international franchises were particularly successful in China included academic and personal development services such as adult education, early childhood education, language classes, fitness classes and skills development. Elderly care and hospitality services were also in demand.

While the pandemic initially brought significant disruption and economic restrictions, China managed to curb the spread of the virus quickly, enabling its economy to begin rapidly recovering while other countries are experiencing economic decline. However, international brands may struggle with their expansion to China due to ongoing travel restrictions and the resulting difficulties in recruiting, vetting and training franchisees, particularly in the cases of multi-unit operators and master franchisees.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The Chinese business association for the franchise industry, the China Chain Store and Franchise Association, has more than one thousand members, including domestic and foreign franchisors, retailers, and suppliers. It was formed in 1997 to promote education and training in the retail and distribution industries, and participates in policy-making related to the operation of chain retail stores and franchises.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

Under the Commercial Franchise Administration Regulation (the Franchise Regulation), individuals cannot offer franchises in the People's Republic of China (PRC). Generally, domestic franchisors prefer to incorporate as either a limited liability company or a company limited by shares.

International franchisors typically prefer to operate in China without establishing a local entity. It is not necessary to open a local subsidiary to grant franchises in China, unless the foreign franchisor wishes to engage in other commercial activities (including leasing or subleasing premises to franchisees), and particularly if the franchisor wishes to exercise the right to take over the franchisee's location in China. Franchisors who decide to incorporate in China no longer need to establish a wholly foreign-owned enterprise or a joint venture company with a Chinese partner, as these types of legal entities were abolished when the new Foreign Investment Law came into force on 1 January 2020. Under the new law, legal entities incorporated in the PRC by foreigners are governed by the same rules as domestic entities, under the Company Law of the PRC (the Company Law).

Forming a joint venture company with a Chinese partner is possible, but generally should be avoided unless there is no other way to establish a franchise in China. Forming a joint venture in any jurisdiction is comparable to entering into a marriage and dissolving a marriage is more complicated than winding down a contractual relationship. Additionally, in the PRC, the day-to-day control of the company's legal representative (similar to a general manager) and company chop is equally – if not more – important than having a majority share in the capital of the joint-venture company. Such control may impede operational efficiency, which in turn may frustrate the purpose of establishing a joint venture with a local partner in the first place.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

The formation of limited liability companies and companies limited by shares is governed by the Company Law and its regulations. The State Administration for Market Regulation (SAMR) and local bureaus for market regulation are responsible for company registrations.

Foreign investors incorporating in China need to file a foreign investor information report with the Ministry of Commerce (MOFCOM) through the corporate filing system maintained by SAMR. If the industry of the target business is on the Negative List, the foreign investor should also obtain approval from MOFCOM.

Requirements for forming a business

5 | Provide an overview of the requirements for forming and maintaining a business entity.

Each business entity must meet certain requirements of the Company Law with respect to the number of shareholders, capital contributions, articles of association, name, and domicile of the company.

For franchisors, the company's scope of business should include offering franchises and the business activities covered by the franchise model.

Upon completion of the registration, the company will obtain a business licence with a unique unified social credit code. Within 30 days after obtaining the business licence, the company should register with the local state tax administration. The company may need to obtain additional licences issued by other government agencies depending on the industry of the business. For example, a restaurant must obtain a food operation licence from the China Food and Drug Administration.

To maintain a business entity, companies must submit an annual report to SAMR by 30 June of the next calendar year. The company must register certain changes (such as changes of name, domicile, place of business, scope of business, etc) with SAMR within 20 days of the change taking place.

Restrictions on foreign investors

6 | What restrictions apply to foreign business entities and foreign investment?

International franchisors who decide not to open a local subsidiary are restricted in certain activities, such as purchasing or leasing real estate for purposes other than self-use.

Most franchising activities are not restricted to foreign investment, but certain industries – including publishing, the wholesale and resale of tobacco, and compulsory school education – remain closed to foreign investment.

Foreign investors should consult the Special Administrative Measures for Access of Foreign Investments (Negative List), updated by the National Development and Reform Commission and MOFCOM, which came into effect on 1 January 2022. The catalogue categorises industries either as 'restricted' (foreign investment is subject to certain restrictions, such as restrictions on shareholding structures) or 'prohibited' (no foreign investment is allowed).

Foreign investors investing in industries that are not on the Negative List will enjoy national treatment.

Taxation

7 | What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

If the foreign franchisor sells franchises in the PRC without establishing a local entity, all remittances of royalties by a Chinese franchisee to the overseas franchisor will be subject to value added tax at a rate of 6 per cent and the withholding tax. The rate of withholding tax on royalties is 10 per cent, unless reduced by a treaty. Management fees and other active income sourced in China are also taxable.

Chinese tax authorities may consider service fees and other payments to be subject to withholding tax if they suspect that these payments are designed to reduce royalties. As Chinese franchisees are better suited to liaise with Chinese tax authorities, franchisors should consider gross-up clauses to shift the burden of dealing with tax authorities to the local franchisees.

If there is no gross-up clause, the franchisor may be able to credit withholding taxes paid in China against the income tax of the franchisor in its home country.

Franchisors selling franchises via a local subsidiary are charged an enterprise income tax at a rate of 25 per cent.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

Employment relationships are governed by the Labour Law and the Labour Contract Law. If the relationship between the parties satisfies the definition of a 'franchise' under the Franchise Regulation, the risk of the franchisee being deemed an employee of the franchisor is very low.

There is currently no indication from the Chinese courts or the Ministry of Human Resources and Social Security that a franchisor may be considered a joint employer of the franchisee' employees, provided that the franchisee maintains a business operation separate from the franchisor.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

China is a first-to-file jurisdiction and trademarks registered abroad are generally not protected. Trademark registration with the National Intellectual Property Administration takes between 12 and 15 months, assuming that the application passes the examination without any amendment notification, official rejection or third-party opposition. The registration is valid for 10 years with an option to renew.

Franchisors should consider registering their trademarks in the PRC as soon as possible and before entering the Chinese market. In addition to any English or other non-Chinese language marks and logos, franchisors should create and register a trademark in Chinese characters before a squatter can register it. Having a Chinese language trademark also mitigates the risk of a franchisee registering the mark in its own name and breaking away from the franchise system. Localising a foreign brand is important to increase the recognition and reputation of the brand among Chinese customers, as English is not widely spoken in mainland China.

Trade secrets are protected contractually as well as under the Anti-Unfair Competition Law and the Criminal Law.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

Land title and real estate leases are governed by the Civil Code.

The land in urban centres belongs to the state and can be leased only for a certain period. Businesses can own commercial units in buildings, but not the land on which the building is built.

To be able to purchase or lease real estate for purposes other than self-use, a foreign entity should incorporate a Chinese company and obtain approvals from the local MOFCOM. With respect to self-use real estate, the branch or representative office of the foreign entity may purchase properties according to its needs. As such, if sub-leasing or lease assignment is part of the franchise system, it is recommended that the foreign franchisor incorporates in China and obtains the government's approval because such practice may be considered as operating a real estate business.

If the franchisee leases the premises directly from a landlord, the franchise agreement should address possible relocation where the franchisee's lease expires before the end of the franchise agreement term, as commercial leases in the PRC are relatively short (between three and five years).

Competition law

11 What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

Article 17(4) of the Anti-Monopoly Law prohibits the establishment of exclusive geographical areas without justifiable cause for players with a dominant market position. Franchisors in China rarely have a market share that is significant enough to constitute a dominant market position.

Price-fixing and minimum resale prices are prohibited in vertical agreements or horizontal monopoly agreements between competitors. However, the Anti-Monopoly Law provides some exceptions for horizontal agreements. The practice of setting recommended prices may attract scrutiny from the anti-monopoly authorities if the franchisor enforces the recommendation. The Anti-Monopoly Bureau of the State Administration for Market Regulation is the primary anti-monopoly authority in the PRC.

Franchisors should observe the price-fixing restrictions under the Anti-Monopoly Law. The authorities actively enforce the law, including against certain industries such as car dealerships.

The courts and government authorities are debating whether a negative effect on competition is required to secure a conviction for a resale price maintenance offence. While the government considers resale price maintenance as a per se offence, which does not require proof of intent or a negative effect on competition, the courts would consider whether price-fixing has lessened or restricted competition on a case-by-case basis.

Article 17 of the Anti-Monopoly Law prohibits tie-in sales clauses imposed by parties with a dominant market position without justification.

OFFER AND SALE OF FRANCHISES

Legal definition

12 What is the legal definition of a franchise?

The Commercial Franchise Administration Regulation (the Franchise Regulation) defines a franchise as an arrangement in which:

- the franchisor through an agreement grants a franchisee the right to use the franchisor's business operating resources, including registered trademarks, logos, patents and proprietary technologies;
- the franchisee conducts business under a uniform mode of operation; and
- the franchisee pays franchise fees according to the agreement.

The Chinese definition of a franchise is quite broad. The Chinese term for franchising includes both business format franchises (as in the United States) and product distribution arrangements. Further, licensing of non-trademark intellectual property rights – such as a trade secret or patented technology – can also fall under the definition of a franchise if a fee is paid and the licensee conducts business under a uniform mode of operation.

Laws and agencies

13 What laws and government agencies regulate the offer and sale of franchises?

The People's Republic of China (PRC) (excluding Hong Kong and Macao) is a civil law jurisdiction, heavily based on the German model. All contracts in the PRC must conform to the general principles set out in the Civil Code. Franchise relationships are governed by the following regulations and administrative measures:

- the Franchise Regulation;
- the Commercial Franchise Registration Administrative Measures; and
- the Commercial Franchise Information Disclosure Administrative Measures (the Information Disclosure Measures).

The Ministry of Commerce (MOFCOM) is the government body that enforces franchise regulations.

Other laws that may affect franchisors include:

- the Labour Contract Law;
- the Anti-Unfair Competition Law;
- the Anti-Monopoly Law;
- the Trademark Law; and
- the Copyright Law.

Principal requirements

14 What are the principal requirements governing the offer and sale of franchises under the relevant laws?

Under the Franchise Regulation, franchisors must meet certain eligibility requirements, offer pre-sale disclosure and comply with mandatory content requirements for franchise agreements. Franchise agreements must include, among others:

- provisions regarding fees;
- the term of the agreement and the nature of the franchise business;
- the standards of operation;
- details of the assistance and training provided by the franchisor;
- the standards of quality of the products or services and quality guarantees;
- the protection of consumer rights;
- the allocation of liability for consumer rights violations between the franchisor and franchisee;
- provisions regarding the promotion and advertising of the products or services; and
- provisions regarding amendment, cancellation and termination of the franchise agreement.

There is no requirement to register a franchise agreement or franchise disclosure document. However, franchisors are required by law to register with MOFCOM or local MOFCOM departments within 15 days of the first franchise agreement being signed. The list of documents required for registration with MOFCOM usually includes, but is not limited to:

- the franchisor's standard form of franchise agreement;
- the franchise agreement signed with the first franchisee in China;
- the corporate registration certificate;
- the market plan;
- registration certificates for trademarks or copyright (eg, logo) used in the franchise system; and
- evidence of compliance with Article 7(2) of the Franchise Regulation (the 2+1 Rule).

All documents must be translated into Chinese. Documents that are prepared abroad must be notarised and either legalised at the Chinese embassy in the country of origin or certified according to the Hague Convention on Abolishing the Requirement of Legalisation for Foreign Public Documents.

International franchisors should register with MOFCOM's head office in Beijing, rather than with local MOFCOM departments. The franchisor should register any changes in the information submitted to MOFCOM within 30 days of that change taking place.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

All franchisors in China must have a mature business model and demonstrate compliance with the requirements of article 7 of the Franchise Regulation. The 2+1 Rule contained in this article requires that a franchisor must have owned and operated at least two outlets for at least one year. According to the practice developed by MOFCOM officials, the outlets may be owned and operated by the franchisor's subsidiaries or, in some cases, other affiliates; the outlets may also be located outside China if they are operated under the same franchise brand. If the outlets are located outside China, franchisors may use statements issued by trade organisations (eg, the International Franchise Association) to show compliance with the 2+1 Rule. Chinese courts generally agree that it is possible to have a mature system without complying with the 2+1 Rule, which in practice means that the franchise agreement will be valid (assuming non-compliance with the 2+1 Rule is properly disclosed), but registering with MOFCOM will be problematic.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

There are no such regulations specifically targeting franchising.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

Franchisors should provide prospective franchisees with a franchise disclosure document at least 30 days before signing the franchise agreement. There is no prescribed format; franchisors may choose to follow the format of the disclosure documents prepared for other jurisdictions or follow the order set out in article 5 of the Information Disclosure Measures. There is no requirement to register a franchise agreement or franchise disclosure document; however, franchisors should register with MOFCOM within 15 days of the first franchise agreement being signed.

There is no obligation to make continuing disclosure, but disclosure must be updated before signing the franchise agreement if there is a significant change in the information provided by the franchisor.

Pre-contractual disclosure – content

18 | What information is the disclosure document required or advised to contain?

According to article 5 of the Information Disclosure Measures, information that must be disclosed to a potential franchisee includes:

- basic information about the franchisor and its management;
- basic information regarding the operational resources of the franchisor, such as the franchisor's registered trademarks, logos, patents, proprietary technology and operational or business format model;
- basic information about franchise fees, such as the type, amount and payment method for franchise fees, any required security deposits, and the conditions and method of refund;
- the terms and conditions for supplying products, services and equipment by the franchisor;
- a description of the continuous services to be provided to the franchisee, including operating guidance, technical support and training;
- the components and method for the operational guidance and supervision provided to the franchisee;
- the investment budget for a franchise location;
- the list of existing franchise outlets within the PRC and an assessment of their business performance (an earnings claim);
- summaries of the financial statements and audit reports for the past two years;
- a description of the franchisor's franchise-related lawsuits and arbitrated matters in the past five years, and of any bankruptcies in the past two years;
- information regarding any record of material illegal operations with respect to the franchisor or its legal representative; and
- a copy of the franchise agreement.

Article 23 of the Franchise Regulation prohibits franchisors from concealing any relevant information, even if not specifically listed. Further, article 500 of the Civil Code prohibits a party from intentionally concealing key facts relating to contract creation. These provisions can be interpreted as a requirement to disclose all material facts, even if this information is not listed in the regulations.

Pre-sale disclosure to sub-franchisees

19 | In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

The obligation to provide pre-sale disclosure to the sub-franchisee rests with the sub-franchisor.

Following the principle of good faith in negotiating and performing contracts, the sub-franchisor should disclose all material facts regarding the franchisor and the relationship between the franchisor and sub-franchisor, for example:

- the ownership of any intellectual property rights used in the franchise system;
- the term of the master franchise agreement;
- if the franchisor is the supplier of products, services or equipment, the terms and conditions of the supply arrangement;
- a description of services (training, marketing, operational support) provided by the franchisor, if any, and franchisor's oversight rights; and
- a description of lawsuits and arbitral proceedings related to the franchise system.

Due diligence

20 | What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

Conducting due diligence on a prospective franchisee is an essential step in a franchise transaction in China. In major urban centres, a lot of information about a corporation can be obtained online (in Chinese), including:

- its shareholders;
- its registered capital;
- its management;
- its affiliates; and
- any past litigation.

At the very least, a franchisor should start by obtaining a copy of the individual's passport or identity card. If the prospective franchisee is a domestic company, the franchisor's lawyers should obtain a copy of the business licence. Business licences disclose the Chinese character name of the corporation that must be used in the contract (even if the contract is in English) to ensure that the contract may be enforced against the franchisee. The business licence also discloses the name of the legal representative, who is the only person who can sign for the company unless he or she issues a power of attorney to another person to sign the agreement.

On the other hand, it is also advisable for the potential franchisee to conduct necessary due diligence checks on the franchisor and the franchise business. In addition to the franchise disclosure document provided by the franchisor to the potential franchisee, the potential franchisee should consider checking the status of the franchisor company and its franchise business, past and ongoing litigations and administrative penalties and the status of its operational resources, such as trademarks.

Failure to disclose – enforcement and remedies

21 What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

MOFCOM has the authority to charge an administrative penalty of up to 100,000 yuan for failure to comply with disclosure obligations, but rarely exercises this authority.

If a franchisor conceals relevant information, fails to provide disclosure or provides false information, the franchisee may rescind the franchise agreement.

Damages can be claimed under the Civil Code; however, damages awards are generally low in franchise cases.

Failure to disclose – apportionment of liability

22 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

There are no statutory rules or guidance from MOFCOM or the courts regarding the liability of the franchisor for non-disclosure or misrepresentation by the sub-franchisor.

General principles set out in the Civil Code, including the principle of good faith in negotiation and performance of contracts, apply to contractual indemnity for disclosure non-compliance or pre-contractual misrepresentation. Under domestic laws, limitation of liability for bodily injuries or death, or exclusion of liability on the grounds of negligence or gross negligence, are unenforceable.

General legal principles and codes of conduct

23 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

The law in the PRC is based on the principle of good faith in negotiating and performing contracts (*culpa in contrahendo*), which is the opposite of the common law doctrine of caveat emptor ('buyer beware'). Further, article 500 of the Civil Code prohibits a party from intentionally concealing key facts relating to contract creation. These provisions support the pre-sale disclosure obligation (including all material facts disclosure) and the obligation to perform a franchise agreement in good faith, which is part of PRC law.

Fraudulent sale

24 What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

Franchisees can apply to court to revoke a franchise agreement that was concluded as a result of fraud or complain to the authorities of fraud. Article 224 of the Criminal Law provides a special charge for fraud in connection with contracts.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

After entering into the franchise agreement, the parties must perform their contractual obligations in good faith. The Commercial Franchise Administration Regulation (the Franchise Regulation) requires the franchisor to provide ongoing operational guidance, technical support and business training in accordance with the franchise agreement, and to disclose to the franchisee any promotional and marketing expenses.

Operational compliance

26 What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

Franchisors typically reserve inspection and audit rights to monitor compliance with the franchise agreement. International franchisors should factor in the costs of site visits to the franchisee's location when determining royalty or other fees. In addition to the audit rights, franchisors should require franchisees to provide copies of tax returns. Monitoring franchisees' Chinese websites is also important.

While having access to the franchisee's computer systems and point-of-sale data is useful to monitor compliance with financial obligations, complete access to franchisees' computers and data is difficult to achieve in the People's Republic of China (PRC), including for privacy law reasons.

Amendment of operational terms

27 May the franchisor unilaterally change operational terms and standards during the franchise relationship?

If the franchise agreement allows the franchisor to change operational terms and standards unilaterally, the franchisor may exercise such contractual rights in good faith.

Policy affecting franchise relations

28 Do other government or trade association policies affect the franchise relationship?

Members of the Chinese business association for the franchise industry, the China Chain Store and Franchise Association, must abide by its code of ethics.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

The grounds for terminating a franchise agreement must be set out in the franchise agreement. Except for the cooling-off period set out in article 12 of the Franchise Regulation, there are no prescribed grounds of termination.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

If a franchisor conceals relevant information, provides false information or fails to provide a disclosure document, the franchisee may rescind the franchise agreement. Franchisee must exercise its right of rescission within one year after they knew or ought to have known the cause for rescission, unless the franchise agreement provides for a longer rescission period (article 564 of the Civil Code). Some Chinese courts have recently denied rescission claims where there was no substantial negative impact on the franchisee caused by failure to disclose, or where the franchisee failed to prove that the failure to disclose had substantially affected its decision to join the franchise system.

Other grounds for terminating a franchise agreement must be set out in the franchise agreement. Except for the cooling-off period set out in article 12 of the Franchise Regulation, there are no prescribed grounds of termination.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

Renewal of the franchise agreement must be evidenced in writing. All formal or substantial requirements for the renewal must be set out in the franchise agreement. A new disclosure is not required if the franchise agreement is renewed on the same terms and conditions. Renewal of a trademark licence must be recorded with the National Intellectual Property Administration.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Subject to any contrary provisions in a franchise agreement, a franchisor is not obliged to comply with a request for renewal.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Franchisees may transfer or sell their franchise only with the franchisor's consent (article 18 of the Franchise Regulation).

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

Fees charged by international franchisors in China typically include:

- royalties;
- initial franchise fees;
- development fees;
- advertising fund fees; and
- interest on late payments, or all of the above.

The type, amount and method of payment of franchise fees are not prescribed by the franchise regulations and must be negotiated between the parties. However, international franchisors should consider some practical aspects when negotiating franchise fees:

- Due to foreign currency exchange regulations, weekly or biweekly payments by a local franchisee to an overseas recipient are difficult to administer. For example, a domestic entity needs State Administration for Foreign Exchange approval to purchase foreign currency exceeding the US$50,000 annual limit. Chinese payors transferring money overseas must submit certain paperwork to the bank, including a tax authority-issued tax recordal form. Therefore, royalty and other regular payments are usually charged on a monthly or quarterly basis.
- As English is not widely spoken in mainland China, adverts targeting Chinese consumers must be in Chinese and adapted to local customs and culture. If an international franchisor charges advertising fund fees, a separate fund for Chinese advertising should be considered.
- If the franchisor charges a pre-contractual deposit, the purpose of this payment and conditions of refund (if the deposit is refundable) must be evidenced in writing.
- Chinese parties are rarely comfortable providing personal guarantees. Instead, domestic franchisors charge a security deposit, which may be returned to the franchisee on the expiration of the franchise agreement if the franchisee has complied with the obligations under the agreement.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

Generally, interest charged on overdue payments is considered liquidated damages. Article 585 of the Civil Code provides that if the agreed-upon amount of liquidated damages is excessively higher than the actual loss incurred by the creditor, parties (generally, the debtor) may request the court to make an appropriate abatement.

The Judicial Interpretation of Private Lending (JIPL), issued by the Supreme People's Court in June 2015, provides that courts must accept and enforce claims of interest under 24 per cent, allow but not enforce claims of interest under 36 per cent and void interest above 36 per cent. Although the JIPL only applies to private lending contracts, in practice courts apply it to other types of contracts.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

Yes. Chinese yuan is still not freely exchangeable, although controls have loosened over the past decade.

Chinese residents must obtain State Administration of Foreign Exchange approval to purchase foreign currency above the annual quota of US$50,000. Foreign exchange controls are primarily enforced by the banks, which monitor all overseas payments made by customers. Chinese franchisees should submit documents evidencing their payment obligations (eg, a franchise agreement) to make the overseas payment. To facilitate payments, franchisors should ensure that all registration requirements (eg, registration with MOFCOM and

recording of trademark licences with the National Intellectual Property Administration) are completed in good time.

Further, banks require payors to submit a tax recordal form issued by the tax authorities. Many tax departments will not issue tax recordal forms until all withholding taxes are paid.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Yes. Franchisors should ensure that their agreements with Chinese franchisees are properly initialled, signed and sealed, and reference the franchisee's legal name in Chinese. Franchisors should collect evidence of the information that has been disclosed and the time of disclosure. Identifying a clear scope of information that is subject to a confidentiality covenant enhances the chances of enforcement.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Yes, the law in the PRC is based on the principle of good faith in negotiating and performing contracts. Article 7 of the Civil Code and article 4 of the Franchise Regulations require the parties to act fairly, honestly and in good faith.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

The authors are not aware of any such laws.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

There is no such requirement. In practice, providing a Chinese language version is highly recommended to avoid a franchisee's claims that the English version was not understood. Chinese translation of the franchise agreement is also required for registration with MOFCOM and enforcement.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

Subject to the duty of good faith, which does not support overbroad restrictive clauses, non-compete and non-solicitation covenants are enforceable.

The franchisor may set recommended prices for franchisees, although this may attract scrutiny from the anti-monopoly authorities if the franchisor enforces the recommendation.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Franchising disputes usually fall under the jurisdiction of either the basic or intermediate people's courts. Specialised intellectual property (IP) courts in some major cities also have jurisdiction over major franchise cases. The level of court that will hear a dispute is determined by the amount of the claim and the status of the party (ie, a domestic litigant or a foreigner). The monetary thresholds differ between provinces. Generally, foreign-related disputes have a lower monetary threshold to be heard by an intermediary people's court or specialised IP court. In other words, it is easier for a foreign party to obtain more sophisticated judges at the trial level and get an appeal heard by higher people's courts.

Domestic franchise disputes are typically heard by local courts. There are few reported court decisions that involve international franchisors, even though international claimants have a good track record of prevailing in local courts. Contrary to popular belief, Chinese courts are efficient and generally friendly to foreign parties.

Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

Subject to the provisions of the Law of the Application of Law for Foreign-Related Civil Relations of the PRC, there are no restrictions on the parties to a foreign-related transaction to select foreign law to govern their franchise agreement. However, the choice of foreign governing law must be considered against the advantages and disadvantages of choosing a foreign dispute resolution forum.

If the franchisee's or guarantor's assets are in the PRC, enforcing a foreign judgment in China may be either difficult or impossible, as China enforces foreign court decisions only on the basis of a treaty or reciprocity with the respective jurisdiction. But China has been undertaking to liberalise the rules on recognising and enforcing foreign judgments, in order to better adapt to the trend of market opening. There is currently no such treaty or reciprocity with the United States, Canada, Australia or the United Kingdom; in such cases, litigation in China is the preferred route. If litigating or arbitrating domestically, Chinese law should govern the agreement to avoid the costs and inconvenience of explaining foreign law to the judge or arbitrator.

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Arbitration – advantages for franchisors

44 What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

The PRC is a party to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958). While Western companies overwhelmingly prefer arbitration to litigation in Chinese courts, arbitral awards must still be approved by a local court for enforcement. This process is as expensive and time consuming as a trial. Further, certain issues (eg, ownership of a Chinese-registered trademark) are unlikely to be eligible for arbitration. Arbitration tends to be more expensive and time-consuming than litigating directly in a Chinese court. However, arbitration may be an effective tool if the franchisee has assets outside China, as arbitral awards are more portable across borders than court judgments.

National treatment

45 In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Subject to the real estate restrictions and restrictions on foreign investment in certain industries, foreign franchisors are not treated differently from domestic franchisors.

UPDATE AND TRENDS

Legal and other current developments

46 Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

At this time, no significant reforms of the franchise regulations have been announced by the government. However, judicial approaches to franchise disputes continue to evolve. One of the recent trends seen in court decisions is that courts expect the franchisee seeking termination of the franchise agreement for failure to provide a franchise disclosure document (FDD) to explain how the absence of the FDD or a particular piece of information affected the franchisee's decision to buy the franchise. This is different from the approach in some other jurisdictions such as Canada, where failure to provide an FDD or certain information leads to the rescission regardless of the impact on the franchisee.

Finland

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

In Finland, franchising is on the rise although it is not as widespread as in most other European Union countries. Despite several success stories and a fairly rapid two-digit growth of 98.67 per cent between 2001 and 2021, franchising is still a poorly recognised business method. The penetration of franchising in the Finnish market is below the European average and Finnish franchising culture has long been considered rather behind. Still, the business and investment climate is favourable, particularly in the aftermath of and recovery from the pandemic. The networks seem very confident of expansion, the financing of which is founded on cash flow in about 50 per cent of all networks.

As at June 2021, the franchising sector in Finland consists of a total of more than 250 networks, 5,000 franchisee entrepreneurs, and about 7,000 outlets that directly employ about 50,000 people and indirectly employ more than 100,000 people. In 2021, the average turnover per outlet was €670,000. The annual turnover of the franchising sector is €6 billion, accounting for approximately 2.56 per cent of the gross domestic product, but franchising (in particular, business-format franchising) is used less than in neighbouring countries such as Sweden, Norway and Estonia. The reason behind this may be the 'loyal servant' sentiment – that is, the apparent preference for being an employee rather than an employer in Finland – that was shaped by ironworks and engineering industry bureaucracy, which still lingers due to strict monthly reporting requirements to the tax authorities. Another possible reason is a latent reluctance to be kept on the franchisor's tight leash.

Like elsewhere within the European Union, in Finland, generally only business-format franchising is recognised. Given this narrow definition, only about 1.6 per cent of all operating enterprises are franchised. The current franchising market can be split into four broad sectors, each of which comprises a variety of businesses:

- consumer services, which accounts for approximately 43 per cent of franchised enterprises;
- business-to-business services, which accounts for approximately 12 per cent of franchised enterprises;
- the retail sector, which accounts for approximately 22 per cent of franchised enterprises; and
- the café, restaurant and fast food sector, which accounts for approximately 23 per cent of franchised enterprises.

Approximately one-third of all franchisees are women, being both younger and having attained a higher degree of education than their male counterparts.

About three-quarters of all franchises originate domestically, with the consumer services sector steadily growing. International franchises are mainly from other European countries, with the majority originating from Scandinavia and Western Europe. Less than one-third of international franchises come from North America.

It is generally recognised in Finland that franchising is suited to serving geographically dispersed local markets where a known trademark and a consistent product or service offering provides assurance to both consumers and franchisees, contributing to balanced regional development and additional entrepreneurial career opportunities for underrepresented groups.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

Out of approximately 250 franchisors, 78 are members of, and 26 associated to, the Finnish Franchise Association (FFA), membership of which is voluntary. The FFA annually publishes a number of reports, the most important of which is the yearbook containing statistics and other data of its member franchisors. The FFA is a member of, among others, the European Franchise Federation and the World Franchise Council. In its capacity as a member of Finland's Entrepreneurs Association or alone, the FFA responds to requests for resolutions or opinions on legislative initiatives and bills, and it is poised to imminently increase its lobbying activity.

To the author's knowledge, franchisees do not have a local or national franchise association.

The FFA has adopted the European Franchising Federation's Code of Ethics in its own FFA Code. Members of the FFA must comply with the FFA Code. This is, however, not a statutory duty. Unless expressly incorporated into a franchise agreement, a franchisee is only permitted to invoke the FFA Code against a franchisor who is an FFA member. Although the FFA Code intends to reflect fair franchise practice, there is no precedent for the FFA Code being regarded as generally setting out such practice.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

The franchisor is likely to choose a business entity that allows it to limit its liability. These entities include a private corporation (a limited

liability company) or a partnership, subject to it being owned by a limited liability company. The typical franchisor is likely to choose the private limited company because of its simplicity of incorporation, no formal capital requirements and well-regulated administration as well as the fact that its shares are easily transferable. Alternatively, the foreign franchisor may elect to acquire an existing company, whether a shelf company or not.

Regulation of business formation

4 | What laws and agencies govern the formation of business entities?

The formation of a limited company is governed by the Limited Liability Companies Act and the formation of a partnership is governed by the Partnerships Act. The Act on Trade Names and the Trade Register Act, and their respective decrees, also apply. The company acquires legal capacity once it has been registered with the Companies Register, which is administered by the Finnish Patent and Registration Office (the PRH).

Requirements for forming a business

5 | Provide an overview of the requirements for forming and maintaining a business entity.

These requirements include filing for entry into and registration with the commercial register held by the PRH, filing for the payment of company tax and value added tax (VAT), accounting for withholding tax on payrolls, regularly effecting employer contributions, and complying with the requirements concerning statutory pension schemes.

Forming a business entity

The memorandum of association must be drawn up, incorporating by reference the articles of association (by-laws). The by-laws must contain the trade name, the municipality in Finland where the office is to be registered and the industry. The memorandum provides the details of the board members (the directors), the auditor and the subscription of shares.

Forwarding the subscription price, whether in cash or kind, is a prerequisite for registration. This should be documented by means of receipt and certificate issued by both the directors and the auditor.

The completion, execution and filing of the start-up notice also serve the purpose of notifying the tax authorities of the existence of the new taxpayer. The registration process with the Companies Register does not generally take long, provided that the name and business proposed is distinguishable from and not found to be confusingly similar to names already registered.

Unless an exemption is granted, at least one director must be a resident of the European Economic Area (EEA). This also applies to the managing director. Whatever entity is being used, if there is no director resident in Finland, another individual must be a Finnish resident to receive service of process. This individual can be a lawyer or consultant hired for this purpose. The auditor should be a Finnish-resident authorised or approved public accountant. There is no need for a foreign entity to provide any local participating capital.

Maintaining a business entity

Whether a company is doing business or is dormant, the directors are responsible for duties such as the maintenance of accounting records in accordance with the Limited Liability Companies Act and the Accounting Act, keeping a register of all shareholders and shares issued, and filing the annual report and auditor's report with the Companies Register, which is subject to public scrutiny.

In addition, for the purposes of value added tax, the tax authorities expect the company to submit monthly and annual tax returns, and make tax account payments. Employers must also pay payroll taxes.

A business entity does not require the owner's physical presence. The incorporation in itself constitutes a permanent establishment for the purpose of any tax treaty. If, however, the employer wishes to employ staff, it must take out policies dealing with pensions, unemployment, injury and sickness insurance. Payment of dividends must also be notified.

Restrictions on foreign investors

6 | What restrictions apply to foreign business entities and foreign investment?

Finland is committed to non-discrimination and subscribes to the principle of free movement of capital, goods, services and labour. Generally, there are no restrictions on ownership unless an acquisition is perceived to put an important national security interest at risk, in which case formal approval must be acquired. Accordingly, there are no distinct specific restrictions preventing foreign franchisors from entering the local market, nor are any specific approvals required. Thus, foreign franchisors face largely the same regulations as domestic franchisors commencing business in the same field. As such, they must comply with a number of registration and statutory requirements applicable to companies and entrepreneurs. Should the foreign company have the option to acquire the title to a franchise, there is no need to register such option. The same applies to development agreements and any agency relationship.

Although most direct obstacles to foreign investment have been abolished, Finland, like most other EU member states, has retained some restrictions that mainly relate to investment from outside the European Union or the Organisation for Economic Co-operation and Development (OECD). The most important national laws restricting or prescribing conditions for foreign investment are the Monitoring Act, the Act on Monitoring of Foreigners' Corporate Acquisitions and the Act on Freedom of Trade.

Apart from certain exceptions, shares and assets can be acquired by foreigners, whether natural or legal persons, without the need for approval by the authorities. Any exceptions are limited to those imposed pursuant to the OECD Code of Liberalisation of Capital Movements, such as any investments that may jeopardise public order, public health, morals, safety or the essential security interests of the country.

In addition, certain types of trade, whether carried out by Finnish residents or foreigners, are subject to monitoring, permissions or licences, which most often entail ensuring that those engaged in the trade are competent, sufficiently committed and able to respond to any liabilities connected to the business.

In general, there are no restrictions should a foreign franchisor wish to acquire real property by means of purchase or to take real property on a leasehold basis. This also applies to the acquisition of business premises and to letting (or sub-letting) premises to the franchisee. This does not pertain to certain areas close to the eastern border that are important for national defence.

Taxation

7 | What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

From the viewpoint of the foreign franchisor, it is worth noting that Finland is a party to the Convention of 1988 on mutual administrative assistance in tax matters and to the Convention of 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises. In addition, there are approximately 100 double tax treaties for the avoidance of double taxation and tax evasion in force, some of which are multilateral and take precedence over national tax law. The most frequent method for eliminating double taxation is the credit method. Where there is no double tax treaty with the country of residence of the foreign taxpayer, the country's tax rights are determined by national tax laws.

Withholding tax at source

Generally, the tax treaties provide for tax on dividends and royalties varying between 5 and 15 per cent to be withheld at source. However, where the EU Parent-Subsidiary Directive is applicable, no withholding tax is levied on profit distribution, such as dividends, to a parent company that directly holds at least 10 per cent of the equity of the profit-distributing company. Where this directive is not applicable, the withholding tax at source on dividends is 15 per cent. For other non-resident corporate bodies, generally the rate of withholding is 20 per cent on profit distribution, interest (where not completely tax exempt) and royalties. For natural persons, the rate is 35 per cent on income from employment, pensions and distributions by employee investment funds, unless otherwise agreed in the tax treaty concluded with the recipient's country of residence. Most other income of non-residents derived from Finland is taxed on an assessment basis.

Corporate income tax

This tax is assessed on the worldwide income attributable to the business, bearing in mind the arm's-length principle. Thus, service fees, interest, royalties and capital gains are included but costs, expenses and losses attributable to the business are deductible. Dividends are generally totally tax exempt both domestically and under either the EU Parent-Subsidiary Directive (subject to the 10 per cent minimum shareholding requirement), or tax-exempt to 25 per cent subject to a double tax treaty between Finland and the country from which the dividends are distributed. The corporate tax rate is 20 per cent. As there are currently no thin capitalisation restrictions, a business can be financed from abroad, but is subject to some rather complicated rules on the deductibility of interest paid in excess of €500,000.

Foreign businesses

According to the general rule, foreign businesses are taxed only on income sourced in Finland. This means that corporate entities are taxed at the abovementioned flat rate of 20 per cent while business partnerships, the variety of which is manifold, are not taxed as such but the net profit calculated and for the purpose of assessment distributed among the partners. Real estate tax is assessed on the taxable value of the property, whether land or buildings. However, should the foreign business have a permanent establishment (PE) in Finland, it will be liable to tax on all income attributable to the PE. Thus, as a general rule, interest, royalties and capital gains are included but costs and expenses attributable to the business are deducted. If a PE's business operation results in loss, such a loss will be deductible during the subsequent 10 tax years, applying the same loss carry-forward rules that are applied in respect of Finnish business entities. However, these rules do not apply should more than half the ownership of the foreign company change hands.

Foreign individuals

Non-Finnish residents are taxed in Finland on income sourced in the country, subject to any applicable treaties for the avoidance of double taxation. Under certain conditions and subject to the approval of an application, salary earners with special expertise may – for a maximum period of four years – be entitled to participate in a regime permitting the employer to withhold, in lieu of income and municipality tax, 35 per cent of salary earned. Otherwise, foreign employees are liable for a progressive tax on their salary or wages should they stay in Finland for longer than six months, regardless of citizenship. At the same time, when their stay lasts no longer than six months, the Finnish employer collects a 35 per cent tax at source on the pay, as well as withholding social security payments unless the pay is effectuated by and encumbers a foreign company. Royalties paid to the holders of intellectual property rights who are not Finnish residents are subject to a 28 per cent tax at source. The tax rate is 30 per cent for capital income and 34 per cent above €30,000.

VAT

In general, goods and services supplied in Finland during business are subject to VAT. The general rate of VAT is currently 24 per cent, although the rate for food, restaurant and catering services is 14 per cent and the rate for categories such as books, subscribed newspapers, cultural events, medicines, fitness services, passenger transport and accommodation is 10 per cent.

Transfer tax

Transfer of title to shares of a private limited liability company is generally subject to a transfer tax of 1.6 per cent of the price agreed. On real estate, the tax rate is 4 per cent.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

The crucial question is twofold: whether the franchisee is put under the direction and supervision of the franchisor and whether he or she lacks responsibility for financial risk. If yes, the franchisee is considered an employee of the franchisor rather than an entrepreneur. Low income alone may constitute a factor that puts the franchisee in a position equal to that of an employee or a consumer. The franchisee may be considered a consumer if the franchisee is submitted to work under the direction of the franchisor where the franchisee's in-person involvement is required, or where the franchisor is entitled to issue new instructions to the franchisee, who is required to adhere to such instructions with the franchisor allowed to monitor his or her actions. The franchisee may also be considered a consumer if the franchisor is permitted to amend, at his or her sole discretion, the franchising concept.

Further, where the commercial benefits of the arrangement are or can easily be transferred to the franchisor (eg, by means of the franchisor being in command of the clients or customers of the franchisee, with the franchisee acting solely in service of the franchisor). It is important to consider the conscious intent of the parties. However, depending on the industry, the franchisor may be justified in dictating far-reaching requirements regarding matters such as the recruitment, education, conduct and continuous training of employees; however, equilibrium must be maintained so as not to deprive the franchisee of the independence that is a prerequisite for being regarded as an entrepreneur.

With respect to the franchisee´s employees, vicarious liability may arise in certain cases where the franchisee is to be regarded as either an employee, an agent or a partner of the franchisor. Despite some statements included in the franchise contract to the effect that the franchisee is not the agent of the franchisor, an agency relationship can still arise, although this is rare in practice. A partnership is formed by the agreement of the partners to carry on business for the achievement of mutual economic gain. Unless liability is restricted, the partners are jointly and severally liable for all liabilities of their partnership.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

To protect trademarks and other intellectual property rights, active surveillance and immediate decisive action against infringements are recommended. For trademarks, to enforce one's rights, one must ensure that the trademark is registered rather than relying on the mere establishment of the mark, symbol or brand. It is risky to attempt to make it evident that the mark is generally well known in the appropriate Finnish business or consumer circles and requires a lot of effort. While this effort is being undertaken, a competitor could be exploiting the trademark.

There are many statutes on intellectual property, such as the Trademarks Act, the Patents Act, the Act on Utility Model Rights, the Copyright Act, the Registered Designs Act and the Act on Trade Names.

The concepts of trade secrets and know-how are fairly well defined. Apart from the consequences of divulging a trade secret as regulated by the Penal Code and the Employment Contracts Act, the latter regarding the duty of an employee not to divulge any business or professional secrets of his employer, there is the Trade Secrets Act. As for know-how, there is no other statutory legal definition than the one contained in article 1(i) of Regulation (EU) No. 316/2014 on block exemptions for technology transfer agreements. As know-how is frequently part of trade secrets, it generally enjoys the same legal protections.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

As freeholds generally require significant capital investment, transferable and often renewable tenancies are exploited by franchisors with a need for space, such as restaurants, hotels, retail stores, vehicle rental businesses and petrol stations. Offered mainly by municipalities for periods varying between 30 and 100 years, in many ways tenancies resemble freeholds: the tenant is expected to erect and maintain the buildings and is subject to real estate tax of 0.6 to 1.35 per cent of the taxable value of the property, depending on the municipality.

Franchisors that do not require an entire building generally lease the business premises, for example a flat or the entire ground floor of a building, thereby assuming the financial and commercial risks. The most common lease term is five to six years, with options of renewal for periods of about three years each. Rent rates are expressed on a monthly basis calculated per utilised square metre, which is frequently pegged to an index or – as in the case of many shopping malls – divided into the capital rent (percentage rent), the maintenance rent and the marketing fee. All utilities, such as gas, water and electricity, however, must be paid as an extra cost. Landlords frequently require a guarantee, which is generally the equivalent of three months' rent and is a bank-held security or collateral.

Where the franchisee is the lessee and it is worthwhile to ensure that a competitor cannot take over the location should the franchise agreement cease, the franchisor may wish to ensure that he or she is entitled either to take over the lease or to replace the franchisee. This may entail a conditional lease assignment between the landlord and the franchisee, or some similar arrangement.

While the relationship between the landlord and the lessee or assignee is regulated by the Act on Lease of Business Premises and the mandatory rules of that act must be complied with, case law suggests that where the premises are sublet as part of a franchise agreement that is considered to be mingled and complex, the Act on Lease of Business Premises cannot be applied.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

Competition rules on vertical restraints and on selective distribution may be of some concern to the typical franchisor. The Competition Act prohibits and exempts agreements, decisions or practices in a similar way to the Treaty on the Functioning of the European Union. The guidelines of the European Commission are applied when interpreting vertical restraints, whether challenged based on the national statute or the basis of the EU Vertical Block Exemption Regulation (VBER). Where competition restrictions affect trade between EU member states, EU antitrust law is directly applied. The agency responsible for enforcement is the Finnish Competition and Consumer Authority (FCCA). Abuse of antitrust rules may, unless deemed minor or unjustified with regard to safeguarding competition, lead to the Market Court (on a proposal by the FCCA) imposing a competition infringement. In addition, the abuser may be liable for damages, whether through tort or contract.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

Given the fact that there is no statutory definition, the prevalent definition is equal to that contained in the European Franchising Federation´s Code of Ethics:

> *Franchising is a relationship which involves a contractual and long-term collaboration between two independent firms, a franchisor and a franchisee, in which the franchisor grants for payment a right to the franchisee to make use of the franchisor´s business format in a pre-described and controlled manner at a certain location of area for a certain period of time*

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

There is no special legislation in this field, but there are several statutory regulations that must be heeded. The most important of these are the Contracts Act, the Unfair Business Practices Act, the Trademarks Act and the Competition Act.

No government agency regulates the offer or sale of franchises, nor is there any regime for registering or recording franchise contracts. It is advisable to have a trademark licence recorded.

Principal requirements

14 | What are the principal requirements governing the offer and sale of franchises under the relevant laws?

It may be inferred from the Contracts Act that there is a legal doctrine that imposes a mutual duty of loyalty on contractual parties. This is widely acknowledged in case law. Accordingly, there is a general contractual good faith and fair dealing requirement to avoid misrepresentations inducing the opposite party to enter into a contract. In some circumstances, silence may amount to a misrepresentation. The franchisor should, as a general rule, endeavour to disclose any and all matters that may affect the potential franchisee's decision to accept the franchise. The content and scope of this duty depend on the merits of the case, bearing in mind the potential franchisee's knowledge and experience. On the other hand, the franchisee is also generally under a duty of care, prompting it to obtain (through its own initiative) available information, such as information on general market conditions and their impact on the business.

The Unfair Business Practices Act prohibits any conduct violating fair business practice. In particular, it prohibits the use of untrue or misleading representations regarding a business, whether one's own or that of another, that are may either affect the demand for or supply of a product, or cause harm to somebody else's business. The Trademarks Act covers the national trademark law and the Competition Act sets boundaries regarding actions considered to restrict competition.

Franchisor eligibility

15 Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

There is no specific legislation or regulation concerning this matter. Nevertheless, where the franchisor is a member of the Finnish Franchise Association (FFA) he or she must adhere to the FFA Code of Ethics, which stipulates that, before setting up a franchise network, the franchisor should have operated the business concept successfully for a reasonable time in at least one unit.

Franchisee and supplier selection

16 Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

There are no statutory restrictions or requirements relating to the manner in which a franchisor recruits franchisees, such as restrictions on or requirements as to the number of franchises or franchisees, their characteristics, the locations of the franchised outlets or the distances between outlets. However, only when the franchisor is a member of the FFA is he or she obligated to comply with the recruitment rules contained in the FFA's Code of Ethics, and thus to those on the recruitment and the selection of franchisees, including their characteristics. This means that a franchisor should select and accept as individual franchisees only those who, upon reasonable investigation, appear to possess the basic skills, education, personal qualities and financial resources sufficient to carry on the franchised business. Moreover, it is noteworthy that there are no 'franchisee anti-poaching rules' to draw on save for one derivable from the Employment Contracts Act on the duty of an entrepreneur to compensate the damage he or she has caused another employer by hiring another employer's employee knowingly for competing work. Thus, franchisee anti-poaching, non-solicitation, non-interference provisions, no-hire clauses and similar restrictive agreements are to be regarded as permitted unless specified under antitrust rules.

Save for general antitrust rules, where applicable, there are no requirements (statutory or otherwise) regarding the manner in which a franchisor may select its or its franchisees' suppliers, such as restrictions on or requirements as to local content of goods and services purchased by franchisor or franchisees. There are also no requirements on the effect of the entry of a franchised network upon local companies or on the yearly growth of the franchised network by some specified percentage.

Pre-contractual disclosure – procedures and formalities

17 What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

Unless abrogated from by some choice of law provision to the contrary, statutorily, the compliance procedure founded on the principle of good faith and fair dealing requires full and accurate written disclosure of all information material relating to the franchise relationship within a reasonable time period prior to the execution of those documents. As this principle is continuous by nature, disclosures must be updated whenever circumstances change. This notwithstanding, in Finland, there is no explicitly prescribed statutory pre-sale due diligence process containing, for instance, a formal franchise disclosure document to be given to those interested in buying a franchise as there is in many other countries. Nevertheless, where the franchisor happens to be a member of the FFA, he or she must adhere to the disclosure rules contained in the FFA's Code of Ethics.

Pre-contractual disclosure – content

18 What information is the disclosure document required or advised to contain?

Statutorily, the compliance procedure founded on the principle of good faith and fair dealing requires full and accurate written disclosure of all information material relating to the franchise relationship within a reasonable time period prior to the execution of those documents. Unless abrogated from by some choice of law provision to the contrary, this principle is unambiguously founded on the sales law applicable to the sale of a franchise, as it is generally recognised as being applicable to the sale of intellectual property rights. This notwithstanding, where the franchisor is a member of the FFA, he or she is, under the disclosure rules contained in the FFA's Code of Ethics, required to comply with at least the following:

- any recruitment, advertising and publicity material, containing direct or indirect references to future possible results, figures or earnings to be expected by individual franchisees, shall be objective and shall not be misleading; and
- no later than a reasonable time prior to the execution of the franchise agreement, the prospective franchisor is to give, apart from the FFA Code of Ethics, full and accurate written disclosure of 'all information material to the franchise relationship', including the proposed franchise agreement.

Pre-sale disclosure to sub-franchisees

19 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

The sub-franchisor (the master franchisee) is responsible for making disclosures to its sub-franchisees. It may be inferred from both the Contracts Act and the sales law that there is a legal doctrine that imposes a mutual duty of loyalty on contractual parties. This is widely acknowledged in case law. Accordingly, there is a general contractual good faith and fair dealing requirement to avoid misrepresentations that induce the opposite party to enter into a contract. In some circumstances, silence may amount to a misrepresentation. Accordingly, the franchisor should, as a general rule, endeavour to disclose any and all matters that may affect the potential franchisee's decision to accept the franchise. The content and scope of this duty depend on the case, bearing in mind the potential franchisee's knowledge and experience. The franchisee is also generally under a duty of care, prompting it to obtain (through its own initiative) any available information, such as information on general market conditions and their impact on the business.

Due diligence

20 What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

Adequate due diligence in respect of certain business considerations, legal matters and the potential local partner provide clues as to the likely success of the franchise. The business and legal considerations include whether the local costs – such as for labour, lay-offs, environmental regulatory compliance, rent, leases and commuting – may prove to be too high for recouping the investment within a reasonable time period. The same is true as to the costs of accountants, audits and business administration, not to mention legal services and the cost of dispute resolution.

For franchises that rely heavily on local supply chains, the question is whether affordable suppliers are available. This is an important factor to consider in light of the notorious Finnish duopoly market for groceries and daily consumer goods. Other questions concern, for example whether, in particular in the metropolitan area of Helsinki, the traffic policy that results in harmful and unforeseeable traffic jams is likely to impact the franchisee, and whether the composition of the product (eg, both the legality and the legal restrictions on products such as tobacco, alcohol and opiates) or the offering of services (eg, healthcare, elderly care, education, kindergarten, etc, licensed or at least strictly supervised) is likely to prove suitable or profitable. How have competing brands performed? Is there an adequate logistical infrastructure to support the franchisor's business operations? What attitude will the local zoning and building supervising authorities (who, from time to time, have exhibited corruptive, niggling and outright mean tendencies) take towards the design of the outlets, necessary parking spots, etc?

Among the legal matters, apart from vetting the legal environment in respect of the industry both present and future, it is important to ensure that the principal trademark – including brands, trade dresses and signs – are adequately protected by intellectual property rights. In respect of the local partner, be it a potential master franchisee, franchisee, area representative or area developer, a background check of him or her as well as any officer is a critical aspect of the franchisor's due diligence. In general, this check includes a trade history search, bankruptcy records, review of criminal and civil records (including pending lawsuits and general business reputation), assets and credit reports. Moreover, one may wish to ensure there are no third-party arrangements or liabilities that may pose a hazard and that the financial status of the potential partner will remain satisfactory.

Failure to disclose – enforcement and remedies

21 What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

It is up to the franchisee to ensure that his or her rights will not be encroached upon. An action may be brought before the Market Court due to a violation of the requirements to provide true and sufficient information if it is founded on a charge of unfair business practice. This court may, however, merely prohibit the franchisor's action and reinforce its judgment with a conditional fine. Any claim for damages – whether contractual, such as those based on breach of contract, or in tort, such as infringement of the disclosure requirements – must be instituted by an action before the competent ordinary court.

Cease and desist orders, sequestration and a variety of precautionary remedies are also available. In extreme situations, the Penal Code describes fraud as well as a number of other offences for the purpose of deterring the production of any false information. Court practice shows cases of criminal charge and conviction for fraud and other felonies, such as quoting untrue profit estimates and non-disclosure of unprofitable experience of franchising. In cases of tort, the main fault is negligence. In the case of contracts, the liability is strict and vicarious regarding the lack of care of employees, agents and subcontractors. The starting point is the principle of full compensation: the franchisee must be restored to the position in which he or she would have been in had the franchisor fulfilled his or her duties. In the event of the franchisee being entitled to rescind the franchise contract, it is likely that the not-yet-amortised expenditure would be recoverable, as well as the estimated loss of future profits from the unit. However, where termination would have been permitted, damages are likely to be restricted to the loss of profits merely for the length of the notice period.

No government agency enforces disclosure requirements.

Failure to disclose – apportionment of liability

22 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Although the sub-franchisor is responsible for disclosure with respect to his or her franchisees, the sub-franchisor may have recourse to the franchisor for untrue or misleading information furnished by the franchisor. When they are acting within the powers of the business entity, individual officers, directors and employees are not exposed to liability except where directors can be held liable for negligence on company legal grounds.

General legal principles and codes of conduct

23 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

Finnish contract law contains, although implicitly, important principles such as freedom of contract, freedom of form, and the principle that a contract based on the consent of the parties is binding and must be negotiated and executed in good faith. Accordingly, the principle of *culpa in contrahendo* is emphasised. The guiding force is loyalty between the parties: each party ought to deal loyally with the other, paying attention to the other party's advantage as well.

The franchise networks that are members of the FFA have established a certain self-regulation by their commitment to comply with the FFA Code of Ethics, which constitutes a set of standards similar to those of the European Franchise Federation (EFF) and, accordingly, deals to a considerable extent with matters relating to the offer and sale of franchises. The member networks furnish the potential franchisee, well in advance of the signature of a binding agreement, with 'any written information capable of being furnished on the franchising relationship between the parties'. The standards on recruitment and advertising are similar to those of the EFF. The same is true when a franchisor imposes a pre-contract on a potential franchisee.

Fraudulent sale

24 What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

The franchisee may apply for a pre-trial investigation as to whether the franchisor has committed fraudulent practices, be that merely a marketing offence or an unfair competition offence. A conviction may result in a fine or imprisonment. Damages, including reimbursement for expenditure, may be recovered at criminal or civil proceedings.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There is no franchise-specific law, but there is court practice and related specific legislation that must be heeded during the length of the relationship. These include the Sale of Goods Act on the supply of commodities and rights – which is analogously considered to be

applicable to services – and, amongst others, the Contracts Act, the Unfair Business Practices Act, the Trademarks Act and the Competition Act. In addition, indirectly, a number of other statutes affect the franchise relationship. These include the Consumer Protection Act, the Employment Contracts Act, the Tort Liability Act, the Product Liability Act and, should parties seeking to settle a dispute have elected for arbitration in lieu of ordinary court procedures, the Arbitration Act. In addition, relative to the covid-19 pandemic, presently there is a host of legislative initiatives chiefly aiming at supporting businesses monetarily, with restaurants, bars and cafeterias among those hit hardest by the closures. However, these have a marginal effect.

Operational compliance

26 | What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

The mechanisms for making sure that operational compliance and standards are adhered to cover, generally, detailed reporting requirements imposed on the franchisee, monitoring of franchisee's business and audit of finances, payment of royalties, etc. Field surveys, ad hoc quality control inspections and financial audits are either carried out by visiting the network or simply remotely. Visiting the network is typically performed by either the franchisor's staff, a proxy, an independent third party specialising in network conformity assessment services or independent auditors furnished with mobile tools, solutions and applications for reporting according to predesigned and agreed programmes. These programmes include checklists, paperless records and video or photographic proof. Digital operation manuals with integrated reporting and monitoring solutions seem to be appearing within many industries.

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

During the franchise relationship, the franchisor must not unilaterally change operational terms or standards except where such change is entirely necessary: that is, compelled by circumstances beyond the control of the franchisor, such as a scarcity of raw materials or components, where the change is founded on legislative factors or where the parties have so agreed. Accordingly, it is a top priority to ascertain that the degree to which the franchisor is permitted to unilaterally change operational terms and standards is thoroughly detailed in the franchise agreement.

Policy affecting franchise relations

28 | Do other government or trade association policies affect the franchise relationship?

Currently, there are no government or trade association initiatives that significantly affect franchising relationships, except for certain plans to streamline corporate taxation, lower the corporate income tax rate and increase the tax on dividends where they are not tax-exempt.

Regarding trade association policies, the importance of the Finnish Franchise Association's (FFA) board of ethics as an authority capable of formulating good franchising practice is expected to grow. A conspicuous feature is the fact that, out of the government initiatives relative to the covid-19 pandemic, so far there is not a single one aiming at alleviating the pressure franchisees experience because of loss of customers, while only rarely do franchisors grant cuts on royalties and franchise fees and nor do lessors and landlords grant discounts on rent.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Where the franchise agreement is for a fixed period, there should be very good cause for the franchisor to terminate the agreement and, in particular, to terminate it without notice. Whether or not the agreement is for a fixed period, much depends on the contents of the contract and the justified expectations of both parties. If the franchisee proves not to be loyal to the network, this is a good cause for termination. This would also be the case if the franchisee, at the conclusion of the agreement, has deceived the franchisor regarding any essential issue – such as regarding their skills, education, personal qualities or financial resources – has breached material contract provisions constantly or repeatedly, or has severely violated the interests of the franchisor resulting in a justified loss of trust. If the franchisee either becomes unable to perform the expected duties or is seriously hampered in performing them due to any other specified circumstance, this is also seen as a good cause.

Franchise agreements frequently contain elaborate grounds for termination, such as non-payment of licence fees, royalties and other monies due to the franchisor, to enable the franchisor to rescind the agreement if need be. It is, however, important to note the franchisee's right to challenge the fairness of the provisions, even late in the day. If the franchisee becomes bankrupt, the general rule is that the principle of continuation of agreements precludes discontinuation of the contract.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

Unless there is a good cause, the termination without notice will not be deemed justified. The threshold for terminating an agreement for a fixed period is much higher. This said, termination with notice is likely to be regarded as justified if the franchisor has neglected core duties such as guidance, training, the duty to supply commodities that the franchisee may be bound to acquire for his or her business, the duty of updating the operating manual or similar instructions, or is favouring or siding with fellow franchisees at the terminating franchisee's expense. Termination without notice is normally seen as justified if the franchisor:

- at the conclusion of the agreement has deceived the franchisee regarding any essential issue, such as the alleged success of any pilot unit or their capabilities for guidance or training;
- has breached material contract provisions constantly or repeatedly; or
- has severely violated the interests of the franchisee, resulting in a justified loss of trust.

It is conceivable that certain consequences of the covid-19 pandemic may be regarded as events that may release a party from his or her contractual duties. This is, however, always subject to such party giving notice, without delay, of the impediment and its effect on his or her ability to perform, and proves that his or her failure of performance is due to a clearly definable external impediment beyond his or her control and that he or she cannot reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract, or to have avoided or overcome it or its consequences.

In Finland, the rule of liability founded on the ambit of control of the party invoking the impediment – in contrast to liability founded on negligence – has been implemented in a number of enactments,

chiefly featuring the sale of goods or services. However, in business-to-business relationships, frequently sales contracts (whether general or not) contain some sort of facilities management clause meticulously defining several events that may constitute an impediment entitling the franchisee to invoke a release of contractual obligations. As sales law is optional, unless by way of exception deemed null or void on basis of some legally clearly regulated reason, such contract clauses prevail over law. Last but not least, the rule of section 36 of the Contracts Act that admits the competent court to adjust an unfair contractual term or a term the application of which would lead to an unfair result may be invoked where the circumstances have changed after the conclusion of the contract.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

Renewals of franchise agreements are subject to agreed procedure, if any, otherwise they are effected without formalities.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

The franchisor can refuse to renew the agreement if it was made for a fixed term and there is no provision to the effect that the franchisee has an option to renew it. Where there is an option clause, it is frequently contingent on the franchisee meeting certain conditions; if these are not met, the franchisor may refuse to renew the agreement.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

It is acceptable to contractually restrict a franchisee's ability to transfer its franchise and such a restriction is, in general, enforceable. The same is true regarding restrictions of transfers of ownership interests in the franchisee's entity. However, an overly strict or long-lasting prohibition may be considered unreasonable and subject to adjustment by the competent court or dispute resolution body permitted to adjudicate, by application of section 26 of the Contracts Act.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

Should a franchisee (or sub-franchisor), exceptionally, be deemed an associated enterprise in the sense of the transfer pricing regime to avoid tax consequences, the arm's-length principle and documentation regime must be complied with.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

Transfer pricing standards also apply to interest. There is no restriction on the amount of interest that may be charged unless it is deemed to be unreasonable or to amount to usury.

Nevertheless, any provision related to the amount of interest is deemed a term of the contract and, therefore, the rules of the Contracts Act regarding adjustment may be applicable.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No. The Bank of Finland provides details concerning money exchange and exchange rates, which is useful for foreign franchisors.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Yes, they are enforceable, though the risk of court-ordered adjustment or setting-aside exists, such as if the covenant is made more extensive than necessary so as to prove unreasonable.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Yes, dealing in good faith has a central position in law, though not necessarily in practice. Finnish contract law contains important principles such as freedom of contract, freedom of form and the principle that a contract based on the consent of the parties is binding and must be negotiated and executed in good faith. One may infer from the Contracts Act that there is a legal doctrine imposing a mutual duty of loyalty on contracting parties. Each party ought to deal loyally with the other, paying attention to the other party's advantage as well. There is a general contractual good faith and fair dealing requirement to avoid misrepresentations inducing the opposite party to enter into a contract. This is widely acknowledged in case law. In some circumstances, silence may amount to a misrepresentation. The principle of *culpa in contrahendo* is emphasised. Accordingly, the franchisor should, as a general rule, endeavour to disclose any and all matters that may affect the potential franchisee's decision to accept the franchise. The content and scope of this duty depend on the case, bearing in mind the potential franchisee's knowledge and experience. The franchisee is also generally under a duty of care, prompting it to obtain (through its own initiative) available information, such as information on general market conditions and their impact on the business.

The compliance procedure founded on the principle of good faith and fair dealing requires full and accurate written disclosure of all information material relating to the franchise relationship within a reasonable time prior to the execution of those documents. As this principle is continuous by nature, disclosures must be updated whenever circumstances change. However, in Finland, there is no statutory prescribed pre-sale due diligence process containing, for instance, a formal franchise disclosure document to be given to those interested in buying a franchise as there is in many other countries.

The Unfair Business Practices Act prohibits any conduct violating good business practice. In particular, it prohibits the use of untrue or misleading representations regarding a business, whether one's own or another, that may either affect the demand for or supply of a product or cause harm to somebody else's business. The Trademarks Act covers the national trademark law and the Competition Act sets boundaries regarding actions considered to restrict competition.

Franchise networks that are members of the FFA have established a certain self-regulation by their commitment to comply with the FFA Code of Ethics, which constitutes a set of standards similar to those of the European Franchise Federation (EFF) and, accordingly, deals to a considerable extent with matters relating to the offer and sale of franchises. The member networks furnish the potential franchisee, well in advance of the signature of a binding agreement, with 'any written

information capable of being furnished on the franchising relationship between the parties'. The standards on recruitment and advertising are similar to those of the EFF. The same is true where a franchisor imposes a pre-contract on a potential franchisee.

Franchisees as consumers

39 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

No. Consumer protection protects consumers only where goods or services are acquired primarily for a purpose other than business or trade.

Language of the agreement

40 Must disclosure documents and franchise agreements be in the language of your country?

No, they can be in any language understood by the parties, unless the network is bound by the European Franchise Federation Code of Ethics. In this case, the documents may be in either Finnish or Swedish, both of which are official national languages. However, if a party is sued at court, generally, any evidentiary documents must be translated into either of the national languages.

Restrictions on franchisees

41 What types of restrictions are commonly placed on the franchisees in franchise contracts?

Duration

In practice, there are no restrictions.

Exclusive territories

Exclusivity can be provided by means of restricting active – but not passive – sales outside the contract territory.

Restrictions on sources from whom a franchisee may purchase or lease products

From an antitrust law viewpoint, the franchisor is free to impose on the franchisee an obligation to purchase the contracted products exclusively from the franchisor or from other entrepreneurs designated by the franchisor, provided that the obligation is not indefinite or does not exceed five years in length.

Restrictions on customers the franchisee may serve

Generally, the franchisor is free to impose on the franchisee an obligation not to sell contract products to resellers outside the network, subject to the condition that the franchisee is free to effectuate cross-supplies to or from other members of the network at any level and the franchisee is not prohibited from active sales to end-users wherever they are located.

Prices franchisees charge their customers

Antitrust law prohibits price-fixing, whether direct or indirect. All horizontal agreements on prices and on other trading conditions are prohibited.

Prohibitions on franchisees soliciting other franchisees' employees

There is no express statutory law on non-poaching agreements restricting another, such as a franchisee, from soliciting the employees of another franchisee. However, it is advisable to take heed of the fact the franchisee so restricted may invoke the power of any court to adjust contract terms. Given the fact that in this field there is very little case law, there is a measurable risk that the court may deem such restriction unreasonable or, at worst, that the franchisee so restricted fits into the direction and supervision of the franchisor, which would jeopardise the independence of the franchisee as an entrepreneur and, accordingly, increase the risk that he or she may be regarded as an employee of the franchisor.

Non-competition restrictions

According to the general rule, provisions that are essential to protect the franchisor do not constitute restrictions of competition. The more important the transfer of know-how, the more likely it is that the restraints create efficiencies or are indispensable to protect the know-how, and that the vertical restraints fulfil the conditions of the European Commission Treaty. A non-compete obligation on products purchased by the franchisee falls outside the scope of the prohibition where the obligation is necessary to maintain the common identity and reputation of the franchised network. In such cases, the duration of the non-compete obligation is irrelevant, provided that it does not exceed the duration of the franchise agreement itself. All the same, to be effective after the expiration of the contract, the non-compete obligation must be related to the contract products and must not only be indispensable to protect know-how transferred by the franchisor, but must also be limited to more than for a reasonable period after the expiry of the franchiser agreement and to the premises or land from which the franchisee has operated during the contract period. In any case, in order not to forfeit the benefit of the block exemption, the 30 per cent market share threshold must not be exceeded. Nevertheless, under the Contracts Act, a non-compete clause may be considered either too restrictive or to unreasonably limit the freedom of the franchisee and, therefore, be regarded as non-binding. Accordingly, there is good reason to give much thought to whether a non-compete clause is required and, if so, to its scope and duration.

Governing law

Generally, a franchise agreement can be subject, in part or in whole, to the law of a foreign country. Nevertheless, the choice of foreign law – whether or not it is accompanied by the choice of a foreign tribunal – does not necessarily prejudice the application of domestic mandatory rules from which no derogation can be made.

Dispute resolution

Finnish law acknowledges contracts on jurisdiction unless there is exclusive jurisdiction. By means of a jurisdiction clause, parties may elect to have any, all, or just certain disputes resolved, whether exclusively or not, in some other jurisdiction or by a certain court, whether in Finland or abroad. Nevertheless, one should bear in mind the fact that, apart from jurisdictions covered by the Brussels and Lugano Conventions and Regulation (EU) No. 1215/2012, the recognition and enforcement of foreign judgments does meet obstacles. Therefore, commercial arbitration is much in favour.

The court's power to adjust contract terms

The overarching stipulation that any contract term that is held to be unfair, or the application of which is deemed to lead to an unfair result, may be adjusted or set aside. Further, pursuant to the Act on Regulation of Contract Terms between Businesses, the Market Court may adjudicate a prohibition and a conditional fine should a franchise contract be deemed unfair to the franchisee.

Courts and dispute resolution

42 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The competent courts in civil and commercial matters are, ordinarily, the civil courts that are the courts of first instance (the district and circuit

courts), the courts of appeal and – as a last resort – the Supreme Court. Leave to the Supreme Court is only rarely granted. Consequently, the number of cases handled by the Supreme Court is low and the number of Supreme Court precedents containing the word 'franchise' can be counted on the fingers of one hand.

However, the Market Court – being a special court assigned competence regarding, for example, disputes on restrictions of competition, unfair competition, public procurement, disputes brought forward by the ombudsperson for consumers and certain disputes between traders – plays an increasingly important role. Alternatively, franchisors and franchisees can agree to submit all or certain disputes to arbitration.

Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

No, there are no restrictions. However, franchise contracts are always subject to the public policy doctrine and the fact that the choice of a foreign law does not prejudice the application of domestic mandatory rules. During litigation, the languages used are the national languages of Finnish or Swedish pursuant to the language legislation.

Arbitration – advantages for franchisors

44 | What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

The finality and enforcement of the award, whether Finnish or foreign (subject to the provisions of the New York Convention 1958), are generally regarded as main advantages. If the parties so agree, confidentiality may be ensured, in contrast to the publicity involved in court procedures. Another important advantage is the flexibility of the procedures and the fact that arbitrators deal in terms of 'market economy': they must work at their highest level in order to ensure their reputation and gain future cases. The main disadvantages may be comprised of three, although debatable, factors: the difficulty at appointing the right individuals for the tribunal, the fact that the outcome cannot be appealed against and, finally, the cost. The arbitrators' expenses must be covered by the interested parties and not by the taxpayer, as is generally the case in litigation.

National treatment

45 | In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Legally, there is no difference. In practice, foreign franchisors are probably treated better, not least because of the respect gained in Finland by a concept that has been successful in foreign markets.

UPDATE AND TRENDS

Legal and other current developments

46 | Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

The frequently invoked and ambiguous concept of good faith and fair dealing has turned out not always to be enough. Nevertheless, thus far, no lobby has come up with a franchise law containing clear and detailed provisions on disclosure, so as to decrease the risk of the potential franchisee being furnished with insufficient, misleading or faulty information prior to entering into the franchise agreement. As a consequence, many franchisors assume that the franchisee has, prior to entering into the contract, an understanding of how to look after his or her interests thoroughly and that any contract holds unless the other party can prove any of the very strictly delimited grounds for nullity. Accordingly, in Finland, there is not as much understanding as in, for example, the United States and many other Western countries concerning sustaining the franchise relationship and active franchisor-initiated guidance, support, and assistance.

There are two very persistent trends, although little development. One trend is the endeavour of many domestic franchise networks to go abroad. Recently, this trend has increased. According to a 2021 investigation, around 8 per cent of the domestically owned networks already had operations abroad, in a total of 36 foreign countries. Some have succeeded and some have met with difficulties, such as those operating in Russia and Belarus. Another trend is the one in which the clear insight into, and grasp of, franchise agreements are kept outside case law. This is a result of the stringency of the courts in upholding almost all clauses referring to dispute resolution by arbitration.

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Franchising is widespread in France. The number of franchise network has doubled over the past 10 years. According to a study lead in 2021 by the French Franchise Association (FFF), there are 1965 franchise networks operating across 79,134 sales areas. The same study specifies that this sector employs 795,441 people and its global turnover amounts to €68.8 billion.

In France, franchising covers a broad spectrum of occupations. Sectors that have historically been dominated by the franchise – which have remained sustainable – include personal and household goods, hotel businesses, food, and hairstyle and aesthetics. New sectors also started franchising in 2016, including fast food and home services. Nowadays, the five most attractive sectors experiencing a strong growth in terms of franchised companies are food, household goods, varied trade, fast food, and personal equipment.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The FFF, founded in 1973, is a national association that brings together franchisors and their franchisees. The FFF aims to represent and serve its members, but also to promote, develop and defend franchising. It is a member of the European Franchise Federation and of the World Franchise Council.

The FFF applies the European Code of Ethics for Franchising, with which members of the FFF must agree to comply. This code is now recognised by most economic operators and by the courts. It establishes a definition of franchising as well as guiding principles and the commitments of every involved party, specifically regarding recruitment, membership and operation of the network, and the contractual relationship.

To join the FFF, the prospective member must submit its membership application and present it to an admission committee. The FFF's board of directors then decide whether or not to grant membership.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

A typical franchisor will have a variety of legal forms to choose from in France, depending on the size of the business, the resources available to the franchisor, and tax and corporate considerations or targets. Usually, the most relevant business vehicle will be a limited liability company (similar to a private limited company in common law countries) since shareholders' liability will be limited to the amount of their investment in the vehicle. There are three main types of business entities.

For small and medium-sized businesses:

- *société par actions simplifiée* (SAS) (that is, a simplified joint-stock company); and
- *société à responsabilité limitée* (SARL) (that is, a limited liability company).

For large businesses: a *société anonyme* (SA) (that is, a classic joint-stock company).

The use of a Societas Europaea (*Société Européenne*) (SE) is very rare in France.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

The French Commercial Code and the French Civil Code govern the formation of business entities. Business entities must be registered with the Trade and Companies Registry where the company has its head office.

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

The requirement for forming and maintaining a business entity depends on the corporate form chosen.

For a SAS, a SARL and an SA, initial registration and annual filings are required. There are additional, ongoing filing requirements such as the obligation to file articles of incorporation (whenever they are amended) and yearly financial statements.

Restrictions on foreign investors

6 What restrictions apply to foreign business entities and foreign investment?

For the most part, no restrictions apply to foreign business entities or foreign investments in France. Decree No. 2017-932 of 10 May 2017

abolished the previous administrative and statistical reporting requirement for certain foreign investments. However, some transactions – such as the sale of at least 10 per cent of the capital or voting rights of a resident company, or real estate investments exceeding €15 million – are subject to a statistical report to the Banque de France (section R152-3 and R152-11 of the French Monetary and Financial Code (MFC)). This report must be made within 20 days of completion of the relevant transaction. Failure to comply with this reporting requirement is treated as a customs violation and is punishable by five years' imprisonment and a fine of up to two times the amount of the transaction.

Courts may also impose a prohibition on exercising a commercial activity or a public function (section 459 Customs Code; sections L165-1 and R165-1 MFC). In addition, foreign investments in 'sensitive sectors' affecting public policy, public security, national defence interests, or activities relating to the production or marketing of weapons, are subject to prior authorisation by the Economy Minister (section L151-3 MFC). The economic sectors considered as sensitive are listed in section R151-3 MFC. They include gaming, private security, pathogenic or toxic agents, and information technology security products and systems. Investments in these sectors must also be reported to the Treasury Department at the time they are actually carried out. If made without authorisation or in violation of the conditions imposed by the Ministry of the Economy and Finance, an injunction may be issued to cancel, rescind or modify the transaction. If such injunction is not complied with, the investor may be fined up to twice the amount of the transaction in addition to the obligation to restore the previous situation.

Taxation

7 What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

There is no specific tax system applicable to franchisors.

They are thus subject to income taxes and taxes on the profits generated by the activity of the franchisor. If the franchisor is a company, it will be taxed, depending on its revenues, at a rate of 15 or 26.5 per cent (with some minor exceptions). The corporate income tax rate is due to decrease to 25 per cent by 2022.

If the franchisor is an individual, he or she will be subject to a progressive tax up to a maximum amount of 45 per cent of his or her income and value added tax (VAT): a flat rate of 20 per cent (and, in certain cases, 10 per cent or 5.5 per cent) applies on all sales of goods or services in France. The fees paid to the franchisor are subject to VAT.

Article 182 B of the French tax code provides that royalties paid by a French company to a foreign entity are subject to a withholding tax in France at a rate of 25 per cent from 1 January 2022). However, pursuant to the treaties for the avoidance of double taxation that have been entered into with most countries, foreign business entities are generally not subject to taxation in France, or subject to taxation at a reduced rate. In light of the specifics of each given situation, this is a matter that calls for personalised advice.

Labour and employment

8 Are there any relevant labour and employment considerations for typical franchisors?

A franchising relationship is one between two independent contractors. However, any interference by the franchisor in the management of the franchisee may result in the independent contractor status of the latter being called into question, and the relationship being held to be an employment relationship. If the courts requalify a franchisee as an employee, the franchisor may be liable for the debts of the franchisee (Supreme Court, labour division, 27 September 1989; Supreme Court, labour division, 3 May 1995, Paris Court of Appeals, 3 July 2002); the franchisee may be awarded damages in case of dismissal (Supreme Court, labour division, 14 December 2006, No. 05-40.844 - Nîmes Court of Appeals, 10 January 2007) and be entitled to paid leave (Supreme Court, labour division, 18 June 2008, No. 06-46.494).

However, the courts rarely requalify a franchise agreement as an employment agreement because the existence of a 'relationship of subordination', required under section L 8221-6 of the Labour and Employment Code, must be unambiguously established. The franchisee is required to prove that his or her activities are carried out under the authority, direction and control (including disciplinary) of the franchisor or employer (Supreme Court, 18 January 2012, Supreme Court, 22 March 2007). Nonetheless, even if the courts determine that the franchisee is not an employee, the franchisee can also benefit, in the context of franchises, from the protective provisions applicable to managers of subsidiaries or branches pursuant to sections L 7321-1 and L 7321-2 of the Labour and Employment Code if the strict conditions laid down by section L 7321-2 are met. In practice, the conditions laid down by that section are rarely met by franchisors. While liberally construed by the Supreme Court in favour of the franchisee, to date the court has required three criteria to be met for a franchisee to qualify as a manager of a subsidiary:

- the activity of the franchisee merely consists of selling goods that are exclusively (or almost exclusively) supplied by the franchisor;
- in premises made available or approved by the franchisor; and
- at prices and under working conditions fixed by the franchisor.

More generally, this requalification will be made when the situation of economic subordination (ie, dependence) entails legal subordination (Supreme Court, labour division, 18 January 2012). As both of these provisions are public policy rules, no waiver of this status by the franchisee in the franchise agreement is valid. However, application of this status does not entail the requalification of the franchise agreement but is limited to the application of the provisions of the Labour and Employment Code to the franchisee: a franchisee who has been requalified as a manager will thus be eligible for the protection afforded in that code (specifically as regards termination of the agreement, working time, paid leave, etc) and benefit from any collective agreements applicable within franchisor's organisation, and may obtain, for example, a refund of the up-front entry fee paid to become a franchisee (Supreme Court, labour section, 14 December 2006).

Lastly, employment law can also apply the franchise network if deemed a 'group' within the meaning of section L 1233-4 or L 2331-1 of the Labour and Employment Code (Supreme Court, labour division, 13 January 2016; Supreme Court, labour division, 16 November 2016). However, since Order No. 2017-1387 of 22 September 2017, a franchise network is not deemed a group provided there are no capital ties between franchisor and franchisee. This will not be the case where the franchisor has a 10 per cent interest or more in the share capital of the franchisee and can exert decisive influence on the franchisee's activity.

To mitigate the above two risks of requalification (as an employee or manager of a subsidiary), the franchisor should be careful not to impose, at any time during the franchise agreement, a subordination link on the franchisee and refrain from imposing prices on the franchisee.

Intellectual property

9 How are trademarks and other intellectual property and know-how protected?

French trademarks are usually protected by way of registration with the French Industrial Property Institute. European trademarks (registered with the European Trademark Office) also enjoy legal protection in France, as do international trademarks (registered with the World

Intellectual Property Organization), provided that they designate France in the registration.

French trademarks are governed by specific provisions of the Intellectual Property Code and, to a lesser extent, by the provisions of the French Civil Code (mainly as regards provisions related to contracts for lease) and of the French Criminal Code (for criminal offences related to counterfeiting).

Traditionally, no specific legislation protected know-how, which was accommodated by the protection of trade secrets and governed by the ordinary rules of law on civil tort liability (unfair competition) or addressed by specific criminal provisions. Considering such protection to be ineffective and insufficient, specific legislation on know-how and trade secrets was enacted on 26 July 2018, transposing the 9 June 2018 Directive (EU) 2016/493 of the European Parliament and of the Council of 8 June 2016 on the protection of undisclosed know-how and business information (trade secrets). This law has been codified in the Commercial Code (in sections L151-1 through L154-1). Know-how is now protected by measures modelled on those existing in intellectual property law (for patents, trademarks, copyright, etc) as well as by competition law (specifically as regards investigatory measures available to the courts). Franchisor may protect its know-how after the end of the business relationship without abuse. For instance, a non-reaffiliation clause limited in time and space as long as it aims to protect the network (Supreme Court, commercial division, 4 September 2018, No 17-17.891).

Real estate

10 What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

The French real estate law aspects that impact franchisees the most are those relating to title (ownership and leases), town planning, authorisations to operate, and health and safety regulations.

Ownership

The main ways to own the operating premises are:

- direct real estate asset purchase: this implies a notary will be involved when drafting and registering the deed of sale with the mortgage registry, and the payment of transfer taxes (around 5 per cent of the purchase price); and
- indirect purchase through the purchase of the company owning the asset: the use of notaries is not mandatory and the basis of the transfer taxes will be deducted from most of the company's debts.

Apart from some mandatory specific warranties, the extent of the representation and warranties in the asset or share purchase agreement is freely negotiable between the parties. Preliminary due diligence is, therefore, usually carried out.

Leases

The leasing of commercial premises in France by commercial companies is strictly regulated by the French Commercial Code.

The commercial lease regime offers strong protection to the tenant, including:

- a minimum nine-year term and exit right for the tenant every three years (except if waived in the lease);
- a cap on yearly increases in rent and (in some cases) on renewed-lease rent;
- a limitation on charges that can be invoiced to the tenant; and
- the right to the renewal of the lease or to the payment of an eviction indemnity covering the loss of ongoing business concern.

Town planning

On top of regulating the aspects and dimension of real estate projects, town planning regulates the authorised types of use, thus restricting the ability to freely operate commercial premises in some designated zones.

Authorisations to operate

Some specific premises require authorisation to be operated.

This is notably the case for retail outlets. Under articles L 751-1 et seq of the Commercial Code, the creation or extension of an outlet comprising sales areas of over 1,000 square metres require prior administrative authorisation from the Departmental Commercial Development Commission (CDAC). The change of commercial use is also subject to prior administrative authorisation from the CDAC. The CDAC notably takes into account the fair repartition of the competition for one type of sale activity in the project's area.

In addition to retail outlets, specific activities requiring authorisations are, among others, cinemas, pharmacies, fuel stations and alcohol sales.

Health and safety regulations

Buildings that are open to the public must comply with fire prevention and accessibility regulations. The local Security and Accessibility Commissions are responsible for checking the implementation of these rules and controlling the compliance of premises with changes of law. Office premises are subject to less restrictive health, safety and accessibility regulations.

Competition law

11 What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

The lawfulness of a franchise agreement is determined in reference to French competition rules – in particular, sections L 420-1, 420-3 and L 442-5 et seq of the Commercial Code – and to European competition rules stemming from the Treaty on the Functioning of the European Union (TFEU), notably article 101 regarding the different restrictions on competition that may be provided in a franchise agreement. These rules are enforceable by French competition authorities and by the courts.

Franchise agreements are covered until 2022 by the Block Exemption Regulation (EU) No. 330/2010, dated 20 April 2010. This regulation is accompanied by the Guidelines on Vertical Constraints, which serve as a guide for analysing the provisions of the regulation and express the European Commission's position concerning how the guidelines should be interpreted and applied.

Since it can be shown that the clauses provided in the franchise agreement are directly related to the accessibility of know-how, the use of the trademark and, more generally, the maintenance of the identity and the reputation of the network, based on this landmark decision:

- such clauses should, in principle, escape the application of article 101(1) TFEU and section L 420-1 of the Commercial Code that punish anticompetitive agreements and practices; and
- the franchisor does not need to show positive welfare effects, on balance, within the meaning of article 101(3) TFEU and section L 420-4 of the Commercial Code.

As of 1 June 2022, a new Vertical Block Exemption Regulation (EU) and accompanying Vertical Guidelines will be effective.

The changes aim to readjust the safe harbour to eliminate false positives and reduce false negatives under this regulation and to provide stakeholders with simpler, clearer and up-to-date rules and guidance that can help businesses to self-assess the compliance of their vertical agreements with article 101 of the Treaty in a business environment

reshaped by the growth of online sales and by new market players such as online platforms, and ensure a more harmonised application of the vertical rules across the European Union.

As regards the draft regulation, a transitional period is foreseen. For a period of one year after its adoption, agreements which are already in force and do not fulfil the conditions for exemption under the new Regulation but do fulfil the conditions for exemption under Regulation (EU) No 330/2010 are not affected by the prohibition in article 101(1) TFEU.

The following outlines some typical provisions in a franchise agreement that can be found invalid or unenforceable (or both) on their own or taken together when they have restricted competition.

Exclusive sourcing clause

The Supreme Court considered that:

> *the exclusive sourcing clause imposed on franchisees was necessary to ensure uniform quality and taste of the products at each of them, manufactured according to the specifications and specific methods [of the supplier], and is therefore a decisive element for the image and the identity of the franchise network[.]*

The lawfulness of this could not therefore be contested (Supreme Court, commercial division, 20 December 2017, No. 16-20.500).

Right of first refusal clause

Franchise agreements often provide a right of first refusal (or pre-emption agreement) to the benefit of the franchisor, in case of the sale or transfer of the premises or the business by the franchisee during the term of the agreement and for a specified term thereafter.

The franchisee must inform the franchisor of any sale or transfer and must ensure that it provides full information to its franchisor, as the period for the franchisor to pre-empt does not begin until the franchisor has received full disclosure (Rennes Court of Appeals, 7 May 2019, No 18/06698 confirmed by Supreme Court, commercial division, 31 May 2021, No.19-17.545). Franchise agreements cannot limit the pre-emption notice to the sole intention to sell or transfer the franchisee; the clause must include all necessary information and document.

Provided that this right of first refusal is justified and does not artificially restrict competition, the courts may decide that the transfer of the business by the franchisee is not enforceable against the franchisor and order the substitution of the transferee by the franchisor (Paris Court of Appeals, 7 October 2016; Supreme Court, 26 May 2006).

In addition, reference should also be made to the provisions stemming from Order No. 2016-131 of 10 February 2016 that reformed contract law, the general regime of obligations and proof of obligations, and section 1123 of the Civil Code. This section introduces the concept of a 'right of first refusal' in the Civil Code and provides penalties in case of its breach, namely:

- a strict obligation to redress the harm or loss sustained; and
- the invalidity or substitution of the third-party transfer if the third party 'knew of the existence of this right and of the beneficiary's intention to exercise it'.

Post-contractual non-compete clause and covenant not to join another franchise network

Most agreements also place the franchisee, after the end of the agreement, under a non-compete obligation or under an obligation to not become a member of a competitor network. This is justified by the fact that the franchisor legitimately seeks to prevent the know-how shared with the franchisee from being used to benefit a competitor.

Pursuant to the Guidelines on Vertical Restraints, Block Exemption Regulation (EU) No. 330/2010 covers both 'an obligation on the franchisee not to engage, directly or indirectly, in any similar business' (point 45, a) and 'an obligation on the franchisee not to acquire financial interests in the capital of a competing undertaking such as would give the franchisee the power to influence the economic conduct of such undertaking' (point 45, b). The Guidelines on Vertical Restraints related to the new regulation have not yet been adopted.

Since 6 August 2016 (Supreme Court, commercial division, 16 February 2022, No 20-20.429) – the date of entry into force of the Macron Law of 6 August 2015 – the validity of the above clause is subject to the following cumulative conditions (section L 341-2 of the Commercial Code):

- it must 'relate to goods and services competing with those covered by the franchise agreement';
- it must be 'limited to the premises and land from which the entity has operated its activity during the duration of the agreement';
- it must be 'essential to protect the know-how, which is secret, substantial and identified, transferred in the context of the agreement'; and
- its duration 'must not exceed one year' after the expiration or termination of the franchise agreement.

The inclusion of a right of first refusal clause in a franchise agreement – applicable for the duration of the agreement and for one year thereafter – combined with a post-contractual non-compete clause could be deemed an anticompetitive agreement, provided that the plaintiff in the proceedings can demonstrate that, based on an analysis of the market and of the economic data, in practice the right of first refusal clause has artificially restricted competition (Supreme Court, commercial division, 3 May 2018, No. 16-27.926). The plaintiff bears the burden of proof.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

There is no statutory definition of a franchise.

However, over the course of time, case law and legal scholars have crafted a definition. For a franchise to be recognised, three main criteria must be met:

- the franchise agreement must entail a transfer of know-how;
- the franchise agreement must include the transmission of the right to use distinctive signs (trade name, trademark or service mark, or both); and
- ongoing commercial and technical assistance by the franchisor during the performance of the franchise agreement.

The transfer of know-how is decisive as it distinguishes the franchise contract from other types of contract. A franchise implies the existence of know-how and its transfer to the franchisee during the course of the agreement. The courts typically assess the existence of this know-how by carrying out a factual analysis of the relationship. If the know-how is not found to exist, the courts can either order the rescission of the contract or award damages for breach of contract by the 'pseudo' franchisor.

Pursuant to the European Franchising Federation's European Code of Ethics for Franchising, of which the French Franchise Association (which is not an official regulatory body) is a member and to which it refers, a franchise is

> *A system of marketing goods, services and technology, which is based upon a close and ongoing collaboration between legally and financially separate and independent undertakings, the franchisor and its individual franchisees, whereby the franchisor*

grants its individual franchisees the right, and imposes the obligation, to conduct a business in accordance with the franchisor's concept. The right entitles and compels the individual franchisee, in exchange for a direct or indirect financial consideration, to use the franchisor's trade name, trademark or service mark, know-how, business and technical methods, procedural system, and other industrial or intellectual property rights, supported by continuing provision of commercial and technical assistance, within the framework and for the term of a written franchise agreement, concluded between parties for this purpose.

Laws and agencies

13 What laws and government agencies regulate the offer and sale of franchises?

There is no specific law or agency regulating the offer and sale of franchises under French law. There is, however, 'soft' law, which only applies where the parties have expressly agreed to be bound by such law. The French Franchise Association (FFF), and the French Standardisation Organisation have issued non-binding rules regarding the contents of franchising agreements. The European Code of Ethics for Franchising has replaced the FFF's former code, and the courts may refer to it even in a case involving a non-FFF member.

More generally, ordinary civil and commercial rules apply, and in particular:

- sections L 420-2 et seq of the French Commercial Code, which prohibit anticompetitive practices where they are intended to fix prices, restrict market access, restrict or control production, opportunities, investment or technical progress, or divide up markets or sources of supplies;
- sections L 442-1 et seq of the Commercial Code, which prohibit restrictive trade practices such as to obtain from the other party an advantage that does not correspond to any consideration or that is disproportionate to the value of the consideration granted, as well as to create intentionally a significant imbalance between rights and obligations of the parties;
- European regulations regarding anticompetitive practices, mainly, Commission Regulation No. 330-2010 of 20 April 2010, along with the Guidelines on Vertical Restraints 2010/130/01, and the new Regulation adopted;
- sections L 330-1 and L 330-2 of the Commercial Code regarding the maximum duration of exclusivity agreements (10 years);
- section L 330-3 of the Commercial Code regarding the pre-contractual disclosure requirement for exclusivity and quasi-exclusivity agreements, specifying that this requirement has been reinforced by a general pre-disclosure requirement under section 1112-1 of the Civil Code (stemming from the reform of general contract law that entered into force on 1 October 2016); and
- sections L 341-1 and L 341-2 of the Commercial Code (stemming from the law of 6 August 2015) on the requirement of a common expiration date for distribution network agreements and on post-contractual non-compete clauses contained in these agreements.

These rules are mandatory rules and cannot be waived by parties.

Competition law aspects of distribution (including franchises) fall within the respective remit of the General Directorate for Competition Policy, Consumer Affairs and Fraud Control (DGCCRF), an administrative body operating under the aegis of the Ministry of the Economy, and of the Competition Authority, which is an independent administrative authority. Both have investigative and prosecutorial powers, including the power to impose sanctions and fines on franchisors and franchisees, owing to their pricing practices or failure to comply with consumer information requirements for instance. In general, the investigative powers of DGCCRF agents and of the Competition Authority depend on the type of investigation involved.

Principal requirements

14 What are the principal requirements governing the offer and sale of franchises under the relevant laws?

Pursuant to section L.330-3 of the French Commercial Code, codifying the provisions of Act No. 29-1008 of 31 December 1989 on the development of commercial and craft enterprises and the improvement of their economic, legal and social environment (the Doubin Act), franchisors are required to disclose pre-contractual information to their franchisees. This requirement is not specific to franchising, but applies to all agreements whereby a party provides another party with intellectual property rights and requires an exclusivity or quasi-exclusivity arrangement, as is typically the case in franchising agreements.

This pre-contractual information must be disclosed in a written document provided at least 20 days before signing the agreement, along with the draft franchise agreement. If applicable, this disclosure must be provided 20 days before any payment made by the franchisee in consideration of the reservation of a territory or specific services to be provided by the franchisor.

Where payment is required prior to signature, especially for the reservation of a territory, the services provided in consideration of that payment must be specified in writing, as well as the reciprocal obligations of each party in case of cancellation.

This document must contain truthful information allowing the future franchisee to freely enter into it on a fully informed basis.

The question that has arisen since the reform of contract law in 2016 is whether the scope of the pre-contractual disclosure obligation has been broadened. Pursuant to section 1112-1 of the Civil Code:

[a] party who knows information that is of decisive importance for the consent of the other, must inform him of it where the latter is legitimately unaware of this information or relies on the contracting party.

In other words, the franchisee must be provided with any information of decisive importance, which is defined as information that has 'a direct and necessary relationship with the content of the contract or the status of the parties'. This choice of wording will doubtless give rise to litigation before the courts. Faced with this type of legal uncertainty, franchisors are advised to be as transparent as possible in the information provided to franchisees. However, in the absence of settled case law on this topic yet, the need to disclose information above and beyond these requirements can be contested, the franchisee being a professional and therefore under a stronger duty to seek out information (Supreme Court, commercial division, 7 October 2014, No 13-23.119), regardless of whether the network is extensive (Paris Court of Appeals, 16 February 2005) or not (Nîmes Court of Appeals, 23 June 2005). However, if the second criterion of 'reliance', which points to the application of a broader disclosure requirement, the framing of section 1112-1 could be construed as meaning that the information must be given without having to verify whether the party to whom the obligation is owed (the franchisee) already knows it and thus that any information known to the franchisor that could influence the franchisee's decision to join the network must be provided to the franchisee.

Failure to comply with this pre-contractual obligation may result in the nullity of the franchise agreement on the ground of fraud (Supreme Court, commercial section, 1 December 2021, n°18-26.572) provided that the franchisee provides that, in the absence of this failure, it would never have consented to the agreement (Versailles, Court of Appeal, 19 November 2020, n°19/01483).

Pursuant to section L.330-1 of the Commercial Code, the duration of all exclusive supply agreements is limited to 10 years. It is, however, possible for the parties to enter into a new agreement upon expiration of this 10-year term, on the main condition that the above-mentioned pre-contractual information is given before the new agreement is signed.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

There is no such legal or regulatory requirement under French law. However, as part of the franchisor's pre-contractual information duties, the franchisor is required to prove its experience and the size of its network. Some legal scholarship and case law consider on this basis that the franchisor must be in the position to demonstrate that it has significant experience and success in similar businesses. The European Code of Ethics for Franchising provides that the franchisor is required to 'have operated a business concept with success, for a reasonable time and in at least one pilot unit before starting its franchise network'. Case law has also recognised a duty to experiment and test the concerned business before franchising it and to request that the franchisor demonstrate that the concept has been profitably operated by it for at least some years before developing the franchise (Paris Commercial Court, 3 July 2009; Paris Commercial Court, 24 September 2009). Similarly, the information contained in the disclosure documentation regarding the franchisor's recent experience and the recent developments in the franchise network must be truthful.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

No specific regulation exists restricting the manner in which a franchisor recruits franchisees or selects its franchisee's suppliers. However, rules regarding non-discrimination could apply and the courts may check that the criteria applied by the franchisor are objective (Supreme Court, commercial division, 25 Jan 2000). Even if a franchise relationship clearly has an *intuitu personae* aspect, the franchisor is free to choose its franchisees, provided it applies clear selection criteria, based mainly on the professional skills and financial resources of the franchisee as well as geographical criteria (to comply with exclusivity arrangements with other franchisees and legal requirements concerning the distance between outlets). In the event that talks are broken off, both the liability of the franchisor or the franchisee may be incurred. Any breach of the duty of fair dealing during the pre-contractual stage can be sanctioned (Supreme Court, commercial division, 26 March 2008; Paris Court of Appeals, 14 March 2018). It is common practice for franchisors to require exclusive dealings from the franchisee (ie, to only buy from approved suppliers specified by the franchisor) or else strict compliance with specifications where the franchisee is free to choose its supplier.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

Pre-contractual disclosure must be made in writing at least 20 calendar days prior to the occurrence of the earlier of the two following events: signature of the franchise agreement; or any payment made by the future franchisee before the agreement is signed, in particular in order to obtain the reservation of a geographic area or specific services from licensor.

Case law usually considers that the disclosure must be updated upon each renewal of the agreement, including in case of tacit renewal or upon the assignment of the franchise agreement by the franchisor. A new general principle of 'good faith' in contractual relationships may also require that the franchisor to disclose any necessary piece of information during the course of the contractual relationships that could affect the relationship. The date to be taken into account is the date the franchise agreement was signed and not its effective date (Paris Court of Appeals, 13 June 2007). The burden of proof of compliance with this pre-contractual disclosure obligation lies with the franchisor (Paris Court of Appeals, 13 June 2007). Similarly, poor performance of this obligation must be proven by the franchisee. Franchisors can also contractually restrict the disclosure or use of their know-how.

Pre-contractual disclosure – content

18 | What information is the disclosure document required or advised to contain?

Sections L 330-3 and R 330-1 of the Commercial Code provide a very precise list of information to be disclosed to the candidate franchisee.

The disclosure document is required to specify the age and experience of the company, the size of the network of operators, the term of the contract, the scope of exclusive rights, and the conditions for its renewal, termination and assignment. Any payment that is required prior to signing the contract, especially for the reservation of a territory or for services provided in return for the specified payment, must be specified in writing, as must the reciprocal obligations of each party in the event of cancellation.

In particular, the disclosure document must provide the following information:

- relating to the franchisor:
  - the company name;
  - the company location;
  - a description of company activity;
  - the company's share capital;
  - the company's registration number;
  - any company bank accounts (this may be limited to the five main bank accounts);
  - the identity of the entrepreneur or of the managers and all indications regarding their professional references and their experience;
  - the date of the company's creation;
  - the principal stages of the company's evolution over the past five years; and
  - annual financial statements for the past two financial years or the annual reports for the past two years if the company's securities are publicly traded;
- relating to the licensed trademark:
  - registration;
  - registration number; and
  - the date of acquisition of the trademark or date and duration of the trademark licence, if applicable;
- any information relating to the state and prospects of development of the relevant market (general and local);
- relating to the network:
  - the size of the network of operators;
  - a list of the member companies with an indication of the network's method of operation;

- a list of the companies (maximum 50) located in France with which the franchisor has entered into the same agreement and the date of conclusion or renewal, or both, of such agreements;
- an indication as to the number of companies that have left the network during the previous year and of the reason why they left the network (eg, termination or expiration); and
- an indication of the presence within the business area of the franchisee of any commercial premises where the products or services concerned are sold;

- information regarding the terms and conditions of renewal, cancellation, and assignment of the contract, and the scope of the exclusive rights.

The disclosure document must also refer to the nature and amount of any expenses and investments related to the trade name, sign or trademark that the franchisee must invest before exploiting those intellectual property or commercial rights.

Pre-sale disclosure to sub-franchisees

19 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

There are no specific provisions regarding sub-franchising structures under French law. However, section L 330-3 of the French Commercial Code applies to 'any person who provides to another person a corporate name, trademark or trade name'. Accordingly, it is up to the sub-franchisor as the contracting party to disclose the pre-contractual information to the sub-franchisee. This obligation would be all the stronger where the sub-franchisor has modified the franchise concept in order to adapt it to the geographical area granted to it by the franchisor. If the franchisor has a direct contractual relationship with the sub-franchisee, it would be advisable for the franchisor to comply with the pre-contractual disclosure requirement.

No specific legislation requires a sub-franchisor to disclose information concerning the master franchisor or its own contractual relationship with the master franchisor. However, based on the requirement under section L 330-3 of the Commercial Code regarding the disclosure of truthful information allowing the franchisee to enter into the agreement on a fully informed basis, the sub-franchisor is under the obligation to disclose all relevant information, which may also relate to the franchisor. This information could consist of the franchisor's name, its location, registration number, professional references, the identity of the managers, the date of the company's creation or the age of the franchise concept. Moreover, the general pre-contractual duty of information reinforces the importance of pre-contractual disclosure between the franchisor and the sub-franchisor.

Due diligence

20 What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

It is indeed recommended for both parties to undertake due diligence before entering into a long-term business relationship.

The authors therefore recommend for the candidate in particular to do the following:

- Contact the network of franchisees. The disclosure document lists the contact details of existing franchisees. As a bare minimum, it is recommended to have the feedback of at least three existing franchisees, some that have been in operation for a while and one that has recently left the network.
- Analyse the growth of the franchise network. The disclosure document provides some understanding of the number of franchisees year on year and the franchisor should be able to supply more historical data. A franchise network showing steady growth is a good sign. A high rate of termination could also indicate that the business may not be sustainable.
- Check the financial statements and request financial data from the franchisor. In particular, it is important to ascertain that the franchise has sufficient financial backing to operate on an ongoing basis. It is important for the franchisee to prepare a business plan and cash-flow analysis for the local market. The disclosure document lists the franchise fees and expenses, both up front and ongoing. It is highly recommended for the franchisor to review the business plan and check the prior experience of the candidate.

Failure to disclose – enforcement and remedies

21 What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

There is no specific government agency involved in the enforcement of disclosure requirements. Any breach would be an issue for the courts that have subject matter and territorial jurisdiction, which enforce disclosure requirements on a case-by-case basis.

Failure to comply with section L 330-3 of the Commercial Code carries criminal penalties (ie, a fine of up to €1,500). Typically, a franchisee chooses to bring an action before the commercial courts rather than filing a criminal complaint. While it is available as a remedy, the commercial courts do not typically impose fines. Accordingly, the remedies available to franchisees are either the rescission of the contract or termination due to breach by the franchisor, if the franchisee can prove that its consent was not valid or that the franchisor committed a material breach (Supreme Court, commercial division, 21 January 2004; Bordeaux Court of Appeals, 12 July 2018). If the court orders the rescission of the contract, the franchisee can obtain a reimbursement of all amounts paid (eg, the upfront entry fee, royalties and any investments made) plus an indemnity for loss of an opportunity and for moral damage (Paris Court of Appeals, 17 Jan 2018). As a general rule, the courts consider that the damage arising from the violation of a pre-contractual disclosure obligation corresponds to the loss of an opportunity to not have contracted or to have contracted on better terms. The loss of an opportunity to earn the income indicated by the franchisor in the pre-contractual documentation is not considered by the courts if considered unrealistic.

There are no punitive damages in France. The courts calculate damages on the basis of the actual loss incurred, taking into account the investment made by the franchisee.

Failure to disclose – apportionment of liability

22 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

There are no legal provisions regulating any sharing of liability between the franchisor and sub-franchisor. This matter should be addressed contractually in the master franchise agreement. However, although the sub-franchisor is directly exposed to liability by having a direct contractual relationship with the franchisee, the franchisor's liability may also be incurred if it has disclosed any erroneous information to the

sub-franchisor or directly to the franchisee (based on a direct contractual relationship or tort).

As far as civil liability is concerned, the general principle is that it rests with the business. Accordingly, the individual officers, directors and employees of the franchisor or sub-franchisor are not exposed to liability unless they were not acting on behalf of the business. They are exposed to criminal liability if they have acted in a fraudulent manner (misuse of company assets, fraud, etc).

General legal principles and codes of conduct

23 | In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

The ordinary rules of contract law, consumer law and competition law apply to franchising. The general principle of good faith in contractual relations enshrined in section 1104 of the Civil Code and the general duty to disclose all information of decisive importance for the consent of the other party, in addition to the information requirements under section L 330-3 and section R 330 of the Commercial Code, may apply to the franchise.

Within the Economy Ministry, the DGCCRF, in the course of its monitoring of the proper functioning of markets to the benefit of consumers and businesses, has the power to monitor and impose sanctions, following investigations and administrative proceedings, or else to refer to the competent courts any violations in the field of franchising. The DGCCRF focuses on price monitoring, fair market practices for consumers, labelling rules, and consumer safety.

In France, the applicable industry code of conduct since 1973 is that of the FFF, which is not an official regulatory authority but is a member of the European Franchise Federation. The FFF now applies the European Code of Ethics for Franchising for all stakeholders in the franchise industry in Europe, which was last updated in January 2017. This code, with which members of the FFF agree to comply, is now recognised by most economic operators and by the courts. It establishes a definition of franchising as well as guiding principles and the respective commitments of the parties, specifically regarding recruitment, membership, operation of the network and the contractual relationship.

Fraudulent sale

24 | What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

Fraudulent or deceptive practices and violation of the disclosure obligations by the franchisor allow the franchisee to bring an action for rescission of the franchise agreement or for its termination due to material breach, and to claim reimbursement of all payments made by the franchisee. The franchisee may also claim damages if it can demonstrate that its consent to enter into the franchise was not valid by reason of fraud. Fraud can also constitute a material breach of contract by the franchisor when it occurs during the performance of the franchise agreement, provided that the franchisee can demonstrate a direct loss.

Legal restrictions on the terms of franchise contracts and the relationship between parties apply in a franchise relationship.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 | What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

No, there are no specific laws regulating the ongoing relationship between franchisor and franchisee during the course of the term of the franchise agreement. The nature of the relationship involved determines what laws apply: contract law, consumer law, competition law, product liability, intellectual property law, employment law, personal data protection laws, etc.

Operational compliance

26 | What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

Franchise systems must be able to monitor their franchisees for system compliance to ensure brand protection, including operation of the franchisee business within the concept and satisfying their other obligations to the franchisor. This monitoring also enables the franchisee to prove that the franchisor complies with its obligation of technical and commercial assistance. Consequently, most franchise agreements give the franchisor the right to audit franchisee compliance, reporting requirements, an obligation of communication of accountant documents by the franchisee and occurrence of 'mystery shopper' visits held by the franchisor. Nevertheless, the franchisor must be vigilant when using mystery shoppers. Indeed, in order to be admissible, evidence must have been obtained in a fair manner. However, when the fault has been provoked by a mystery shopper, the resulting evidence is unfair and the franchisor cannot use it (Supreme Court, commercial section, 21 November 2021, No. 20-14.670). However, this monitoring does not necessitate interference of the franchisor in the management of the franchisee.

Such a clause must be carefully drafted and operated in practice. Indeed, for example, the French courts generally authorise a franchisor to issue instructions with a direct impact on the working conditions of franchisees' employees, provided that this is necessary to maintain the reputation and the uniformity of the franchise network. If the franchisor issues direct and nominative instructions to franchisees' employees or gets involved in hiring or firing, and more generally interferes in the management of the franchisee beyond its technical and commercial assistance obligations arising from the franchise agreement, the franchisor might be held to be the de facto manager of the franchisee and be liable for serious wrongdoing should it cause, for example, the franchisee's insolvency. Therefore, the franchisor may be ordered to cover the liabilities of the bankrupt franchisee or the dismissal of the franchisee's employees.

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

Usually, the franchise agreement (or any contract) cannot be modified unilaterally by the franchisor or the franchisee. Therefore, the parties must conclude an addendum. Furthermore, prior information must be organised between the franchisor and the franchisee regarding the different modifications to be made.

However, it is true that the franchisor also has an obligation to evolve the system. For franchisees, franchisors should be duty-bound

to develop and innovate the system, and keep it competitive against other similar systems. Such changes could happen during the operation of the franchise agreement. Therefore, in order to avoid seeking the franchisee's consent on this evolution, the authors would recommend inserting an evolution clause that strictly defines the scope where the agreement of the franchisee would not be required and the right to modify, for example, the operational manual from time to time. This clause must be clearly drafted especially if, in practice, it could lead to financial or important operational constraints for the franchisee.

Policy affecting franchise relations

28 Do other government or trade association policies affect the franchise relationship?

There is no government policy that significantly affects the franchise relationship. Regarding trade association policies, the European Code of Ethics for Franchising and the French Standardisation Organisation standard (NF Z-20 000), which are non-binding rules, provide guidelines to their members on good practices to be implemented in their franchise relationships. The European Code, for example, contains guiding principles and sets forth the respective rights and obligations of the franchisor and of the franchisee, specifically in terms of:

- recruitment;
- membership;
- the operation of the network; and
- the contractual relationship before, during and after the termination of the franchise agreement.

Termination by franchisor

29 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

A franchise agreement is typically entered into for a fixed term and can be successively renewed per the terms of the agreement. If the agreement is not renewed, the contractual notice period must be complied with. Such notice is required to be 'reasonable' so as not to run afoul of the provisions of section L 442-1 (II) of the Commercial Code on sudden termination of an established business relationship.

Unless the agreement contains a specific clause permitting termination by the franchisor in certain circumstances pertaining, for example, to the revenue made with the franchisee, and unless the franchisee has committed contractual breaches, early termination by the franchisor is not possible. In practice, termination of the franchise relationship at the initiative of the licensor occurs if the franchisee fails to pay the franchise royalties or for the goods delivered by the franchisor, or commits material breaches of the franchise agreement, such as failure to respect the concept, disclosure of know-how, infringement of the franchisor's intellectual property or failure to comply with exclusive sourcing requirements. Under no circumstances is the opening of insolvency or similar proceedings against a franchisee grounds for termination of the franchise agreement under the applicable mandatory public policy rules. The termination clause contained in the franchise agreement authorises the franchisor to directly terminate the agreement without having to go through the courts.

The formalities indicated in the agreement should be complied with. Typically, a termination clause requires a notice of breach, a time frame (or not) in which to cure the notified breach and the effective date of termination. If the franchise agreement does not contain a termination clause but is terminated by the franchisor, the matter would ultimately be decided by the courts in the event that the franchisee challenges the termination. The provisions introduced by the contract law reform in 2016 on the rescission of contracts could have an impact on the franchise relationship (sections 1224 through 1230 of the Civil Code), given that they have incorporated major changes. In summary, in the Civil Code:

- The term résolution (rendered here as rescission, and previously used as a generic term for ending an agreement) has replaced the term résiliation (rendered here as termination for the future), the use of which is now reserved to cases where a court cancels an agreement without ordering restitution of any services that have already been performed (section 1229(3)).
- The franchisor may, at its own risk, after having given notice of breach to the franchisee, rescind the agreement by notice sent to the latter in case of continuing breach (section 1226).
- In any event, rescission can also be requested from the courts (section 1227).
- Where the acts of performance exchanged were useful only on the full performance of the agreement that has been rescinded, the parties shall restore the whole of what they have obtained from each other (section 1229(3)).
- Dispute resolution clauses (arbitration clause in particular), as well as confidentiality and non-disclosure clauses, survive the end of the agreement (section 1230).

Case law has also extended the survival of the limitation of liability clause (Supreme Court, commercial division, 7 February 2018). A rescission possibility is now also open to both parties in the case of unforeseen economic circumstances not contemplated by the agreement that arise during the term of the franchise agreement and that place an excessive burden on a party (ie, hardship). Section 1195 of the Civil Code permits the rescission of the franchise agreement by mutual agreement between the parties if the franchisee refuses to renegotiate the terms of the agreement.

Termination by franchisee

30 In what circumstances may a franchisee terminate a franchise relationship?

The rules applicable to termination are the same for franchisors and franchisees. In a 28 February 2018 ruling, the Paris Court of Appeals ordered a franchisee to pay damages to the franchisor due to wrongful termination, on the grounds that 'the voluntary cessation' of the franchisee's activity was not grounds for early termination under the terms of the agreement.

Renewal

31 How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

Franchise agreements are subject to the common rules of contract law and are not necessarily concluded for a fixed-term duration. Generally, parties conclude a franchise agreement for a period of five to 10 years, and provide a specific clause specifying the terms and conditions of the renewal of the franchise agreement. Thus, whether the requirements are formal or substantive depends on what is indicated in the specific provisions.

A franchisee has usually no automatic right to renew its franchise agreement. Thus, courts often rule that the franchisor would not be liable if it decides not to renew the franchise agreement (Court of Appeals, Paris, 12 January 2005, No. 03/02283; Court of Appeals Versailles, 24 January 2017, No. 15/00955). The franchisor does not have to justify its decision not to renew the franchise agreement and the franchisee usually cannot claim any compensation (Court of Appeals Versailles, 14 March 2017, No. 15/00146). In the case of the renewal of a

franchise agreement with a fixed term, in any event, the renewal involves a new franchise agreement and therefore, the franchisor must provide the franchisee with a new pre-contractual information document.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Unless otherwise contractually agreed, the franchisee has no right to obtain the renewal of the franchise agreement when the latter has been entered into for a fixed term and been performed through to its term, and any notice that is owed contractually or legally has been respected. This principle is now enshrined in section 1212(2) of the French Civil Code ('No-one may require the renewal of the contract'). Accordingly, unless the refusal to renew is unfair or sudden, the franchisor is not liable for any indemnity payment on the mere basis of non-renewal, even in the absence of cause for non-renewal. The franchisor is under no obligation to give reasons for the decision not to renew. The franchisor's liability can only be incurred if the decision not to renew the agreement constitutes an abuse of right, which must be demonstrated by the franchisee. Proof of the abuse of the right cannot be brought simply on the basis of the expression of a refusal, the unjustified nature of such refusal, proposing the signature of a different agreement, the mere fact that there is an economic imbalance between the parties or the franchisor's decision to prioritise the opening of branches in developing the franchise. Lastly, abuse of the right not to renew the franchise agreement may constitute an 'intentional wrongdoing' by the licensor (Supreme Court, commercial division, 4 September 2018). Case law in liability cases claiming abusive non-renewal by the franchisor primarily involve the reorganisation of distribution networks.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

A franchise agreement is typically deemed to be concluded *intuitu personae*, at least where the franchisee is concerned. This being the case, in the absence of a clause permitting transfers of the franchise agreement, the franchisee cannot transfer the agreement without the consent of the franchisor. It is, of course, possible to contractually restrict the franchisee's ability to transfer its franchise by requiring, for example, the franchisor's approval in case of the sale of the franchisee's business. Contrary to the transfer of the franchise agreement, transfers of ownership in a franchisee entity (change of control), inasmuch as that legal entity remains the same, do not infringe the intuitu personae nature of the franchise agreement. Unless otherwise provided in the franchise agreement, such a change of control in no way requires the prior approval of the franchisee (Lyon Commercial Court, 12 June 2015). If an *intuitu personae* clause allows for early termination of the franchise agreement, it must be for the benefit of both the franchisor and the franchisee. If it is only for the benefit of one of them, it is considered a clause causing a significant imbalance and will be cancelled (Court of Appeal, Paris, 5 January 2022, No. 20/00737).

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

There is no law or regulation affecting the nature, amount or payment of fees.

However, the pre-contractual information document is required to contain the financial details of the agreement proposed by the franchisor, and therefore to specify any upfront entry fee, the amount of the royalties and how they are calculated, as well as the terms of payment. The document should also contain an estimate of the overall investment required to open the franchise.

Case law also posits that the franchisor is required to allocate advertising and promotional fees to advertising and promotion, and to provide evidence thereof to the network (Versailles Court of Appeals, 29 September 2015).

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

The amount of interest that can be charged on overdue payments is determined by the parties. However, section L 441-10 of the French Commercial Code provides a minimum rate of three times the statutory interest rate. If no rate is provided by the agreement, the rate applied would be 10 per cent over the official interest applied by the European Central Bank to its most recent financing operation. While no specific legal provision deals with maximum interest rates, the imposition of unreasonably high rates, in particular regarding commercial practices, could be considered as manifestly abusive and thus prohibited under section L 441-16 and L 442-1 of the Commercial Code. Creditors may also claim damages for any harm and costs they may have suffered as a result of late payments.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No. The parties may agree to make payments in the currency of their choice.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are enforceable. As one of the essential characteristics of the franchise agreement is the transmission of know-how, this supposes the possible conclusion, during the negotiation phase, of a confidentiality or non-disclosure agreement. The main objective of a franchise agreement consists of the reiteration of know-how, therefore the negotiations themselves involve the sharing of confidential information, even if that information does not necessarily correspond to the know-how itself. For example, this information may enable the franchisee candidate to assess the quality of the method to be transferred, as well as information about the network that the candidate is contemplating joining. Similarly, most franchise agreements contain, so as to protect the franchisor's know-how, a confidentiality clause whereby the franchisee undertakes not to disclose such know-how to third parties. In the case of litigation concerning the breach of this type of clause (and thus the termination of the franchise agreement by the franchisor based on such breach), the courts may restrict its scope of application, for example by excluding information that is in fact already publicly available or a scope insufficiently limited in space (Court of Appeal, Toulouse, 18 November 2020, No.19/00757; Court of Appeal, Angers, 10 November 2020 No.16/01971). Since the 2016 reform of contract law, section 1230 of the Civil Code also expressly provides that confidentiality clauses expressly survive the agreement.

Good-faith obligation

38 Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Pursuant to section 1104 of the French Civil Code, agreements must be negotiated, concluded and performed in good faith. This general contract rule fully applies to franchise agreements. It implies, in particular, an obligation of loyalty and cooperation at all stages of the performance of the franchise agreement.

Franchisees as consumers

39 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

Only consumers and non-professionals benefit from consumer law protection. The rationae personae scope of consumer law is, therefore, sometimes difficult to establish. The legislator defined the notion of consumer for the first time in Act No. 2014-344 of 17 March 2014 (popularly known as the Hamon Law). Previously, it was left to the courts to define what consumer meant. The legal definition established is broad, as is codified in the preliminary section of the French Consumer Code as referring to 'any natural person acting for purposes other than his commercial, industrial, craft, profession or agricultural activity'. The definition of a consumer given in article 2-1 of Directive No. 2011/83/EU on consumer rights is 'any natural person who, in contracts covered by this Directive, is acting for purposes that are outside his trade, business, craft or profession'. Legal persons, therefore, fall outside the scope of the definition of 'consumer'.

Order No. 2016-301 of 14 March 2016, which entirely recast the legislative part of the Consumer Code, added to the preliminary section of the Consumer Code the category of 'non-professional'. The definition of a non-professional was simplified by Act No. 2017-203 of 21 February 2017, which ratified the order and defined a non-professional as 'any legal person who is not acting for professional purposes'. Accordingly, unlike a consumer, a legal person can benefit from status as a non-professional. However, a non-professional can only benefit from the provisions of the Consumer Code that specifically cover non-professionals. The same preliminary section of the Consumer Code defines a professional as 'any natural or legal person, public or private, acting for purposes related to his commercial, industrial, craft, profession or agricultural activity, including when he acts in the name or on behalf of another professional'.

It is not always easy, in the practice of consumer law, to determine who qualifies as a consumer, a non-professional or a professional. The Supreme Court has adopted a stance in this respect in two rulings dated 29 March 2017, in which it held that a 'legal person acting for purposes which are outside its commercial, industrial, craft, profession or agricultural activity' can qualify as a non-professional and thus benefit from consumer law protection. Accordingly, if a franchisee is a legal person and acts in the scope of its franchising activity, it will not be protected under consumer law.

Language of the agreement

40 Must disclosure documents and franchise agreements be in the language of your country?

There is no specific legal requirement that the disclosure document or the franchise agreement be written in French. However, to avoid any future argument that the licensee did not consent to contract on a fully informed basis, it would be safer for the documents and agreements to be drafted in French or else translated into French.

Restrictions on franchisees

41 What types of restrictions are commonly placed on the franchisees in franchise contracts?

There are generally no restrictions on provisions in franchise contracts. A notable exception concerns competition law.

Courts and dispute resolution

42 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The French court system has two separate orders: administrative courts and judicial courts. The court before which a dispute is brought depends on the subject matter and the amount at stake.

The judicial or 'ordinary' court system is comprised of civil, commercial and criminal courts. A dispute involving a typical franchise agreement falls within the jurisdiction of the ordinary courts, of which there are three levels: the commercial court (court of first instance), the court of appeals and the Supreme Court. A franchise dispute may also be subject to arbitration if the franchise agreement contains an arbitration clause or if the parties so decide when the dispute arises.

Mediation as an alternative dispute resolution method is also available.

Governing law

43 Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

The franchisor and the franchisee can freely choose the governing law of their contract.

However, the application of French mandatory rules cannot be waived by parties and they will be applied by the French courts if any are applicable.

For instance, regarding section L 330-3 of the Commercial Code concerning the pre-contractual disclosure requirement, there is a debate whether it is a mandatory rule or not. Under the 30 November 2001 decision of the Paris Court of Appeals, section L 330-3 of the Commercial Code is not a mandatory rule applicable within the international legal order. However, in a later decision (Paris Court of Appeals, 25 October 2011 No. 10/24023), the same court applied section L 330-3 of the Commercial Code to a contract, notwithstanding the designation by the parties of a foreign law as the law of the contract.

Also, a French court may refuse to apply any provision of the governing law that it considers to be manifestly incompatible with French public policy.

Arbitration – advantages for franchisors

44 What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

The principal advantages are as follows.

- The parties may choose one or more arbitrators specialising in the law or in a given field, depending on the specifics of the dispute. For example, an arbitral panel may be composed of one lawyer and two technical specialists or by a lawyer, a businessperson and a technical specialist.
- Arbitration is confidential. Hearings are not open to the public. Parties not wishing their case or certain related aspects to become public knowledge have every interest in resorting to arbitration.

- Arbitration avoids jurisdictional conflicts between courts, in particular in international disputes and more generally in conflict-of-law issues. It therefore offers greater security than judicial resolution.
- Enforcement is possible everywhere.
- Arbitral awards have the force of judicial decisions and can be easily enforced abroad through international arbitral conventions to which many countries are signatories.
- Arbitration is expeditious.
- The time period in which the award must be entered is set by the parties or, otherwise, by the Rules of Arbitration.
- Challenges of an arbitral award are limited in scope.

The main disadvantage can be the cost of arbitration.

National treatment

45 | In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Foreign franchisors are not treated differently from domestic franchisors.

Pursuant to the provisions of section L151-1 of the Monetary and Financial Code, financial dealings between France and abroad are unrestricted. However, in certain limited sectors (such as those involving national defence or affecting public order, or activities that are essential to secure the interests of the country), section L151-3 of the Monetary and Financial Code submits foreign investors to a prior authorisation process.

UPDATE AND TRENDS

Legal and other current developments

46 | Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

As of 1 June 2022, the Block Exemption Regulation (EU) No. 330/2010, dated 20 April 2010, will be renewed by a new Block Exemption Regulation (EU) and its accompanying guidelines.

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

The latest statistics for 2021 of the German Franchise Association eV show positive developments in the franchise sector: circa 1,000 franchise systems nationwide counted over 140,000 franchise partners, with an increase of 2.2 per cent compared to the previous year, and reaching an overall turnover of €135.8 billion. The most franchised industries are services (44 per cent), followed by gastronomy, tourism and leisure (30 per cent), trade (19 per cent), and crafts, construction and refurbishment (7 per cent).

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The most important franchise association in Germany is the German Franchise Association eV, with circa 450 member companies. It issues legal opinions on draft legislative acts, as well as guidelines and practical advice on newly introduced franchise related laws or regulations. Those who wish to become members must comply with its code of ethics, stipulating practical guidelines of best practice and fair dealings between franchisors and franchisees and regulating issues such as pilot projects, rights of use regarding the corporate identity and training for the franchisees.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

The franchisors' choice depends especially on the obligations and liability risks to be undertaken, the seed capital and business assets and tax implications connected thereto. Most popular for medium or large businesses is the company with limited liability (GmbH), a flexible private limited liability company, which requires a minimum share capital of €25,000 and limits liability with regard to creditors to the company's assets. Bigger businesses might choose the corporation (AG), namely a public limited company that requires a minimum share capital of €50,000. As an alternative, the entrepreneurship (UG), also known as 'mini GmbH', also provides for limited liability, but with a share capital of €1. If the franchise system shall be set up in different states of the European Union, another option is the Societas Europea (SE), a public limited company requiring a minimum share capital of €120,000. For tax reasons, such corporations are often combined with partnerships (eg, as GmbH &Co KG or AG Co KG).

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

The Civil Code (BGB) and the Commercial Code (HGB) regulate the incorporation of partnerships, while the Limited Liability Company Act (GmbHG) governs the formation of a GmbH or a UG, the Stock Corporation Act (AktG) the formation of the AG and the Council Regulation (EC) No. 2157/2001 of the SE.

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

Compared with an AG, the GmbH and even more the UG are less formalised, easier and cheaper. One-person foundations are allowed and founders can be German or foreign natural and legal entities. The incorporation agreement requires as minimum information: the full name and registered office of the company, object of the enterprise, amount of the share capital, and the shareholders' contributions. Once certified by a notary, it must be registered with the Commercial Register by the competent local court (Amtsgericht). The entries in the Commercial Register are published in the Electronic Federal Gazette.

Restrictions on foreign investors

6 What restrictions apply to foreign business entities and foreign investment?

In principle, foreign business entities are free to do business and invest in Germany. However, thorough reviews by the German Federal Ministry for Economic Affairs and Energy and notification obligations apply to acquisitions in specified industry sectors related to public order and security, such as defence, IT, telecoms and critical infrastructure, unless they are made by individuals or business entities based in the European Union, Iceland, Liechtenstein, Norway (the European Economic Area) or Switzerland (based on sections 55-62 of the Foreign Trade and Payments Ordinance). Moreover, the EU and its member states are cooperating on the screening of foreign direct investments into the Union: Regulation (EU) 2019/452 was implemented in Germany by the statutory amendments of the Foreign Trade Act.

Taxation

7 | What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

Further to the entry in the Commercial Register, all German tax-resident business entities are automatically registered with the Tax Authorities. To avoid penalties, tax declarations must be submitted by 31 July or by tax accountants by 28 February thereafter. The income tax, which is usually the highest tax, is calculated based on the profits indicated in the last tax declaration: for AGs or GmbHs, a corporate income tax of 15 per cent of the taxable income is due, while individuals or partnerships are subject to a progressive income tax of up to 45 per cent. Most companies are also subject to a trade tax, whose amount usually varies between 7 and 18 per cent and is determined on a local basis by the competent municipality.

If the franchisor employs workers, a wage tax is due with the monthly pay slip. If the object of the franchise is goods or services, a VAT of 7 per cent (limited to the taxi, hotel or public transport industry) or 19 per cent, applicable to most sectors, is due on the net price.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

Yes, franchisors must take care – both in the franchise agreement itself and in any additional regulations, especially the franchise manual – not to limit the franchisee's freedom too much, thus avoiding making the franchisee subject to the highly protective employment and social security laws. The franchisor must also make sure to live up to the contract, as the parties' conduct prevails over the wording of their contract (cf German Federal Court, 11 October 2018, Case No. VII ZR 298/17; Rohrßen, *ZVertriebsR* 2019, 323).

To reduce this risk of a qualification of employment, the franchisor shall draft and practically implement the franchise agreement in a way that leaves the franchisee sufficient leeway to exercise a self-employed activity, avoiding any implications that the franchisee was personally and economically dependent on the franchisor. If there is a contradiction between the agreement and its actual implementation, the latter is decisive.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

Franchising, trademarks and know-how go hand in hand and therefore their protection is of utmost importance. Trademarks are protected by registration, by acquisition of market recognition or notoriety. The registration at national level is a quite speedy and inexpensive process and is filed, online or with a paper-based application, with the German Patent and Trade Mark Office (DPMA) in Munich. To obtain protection across all member states of the European Union, the filing shall be submitted to the European Union Intellectual Property Office (EUIPO) in Alicante. For international protection, the application shall be filed with the World Intellectual Property Organization (WIPO) in Madrid. In all cases, the protection starts on the filing date and initially lasts 10 years. It can be renewed for further 10-year periods, upon payment of the renewal fee. Innovations can be patented, but the know-how contained, for example, in handbooks and best practice guidelines does not always meet the necessary technical requirements. Therefore, it can be best protected by non-disclosure agreements, subject to Directive (EU) 2016/943 on the protection of undisclosed know-how and business information (trade secrets) against their unlawful acquisition, use and disclosure, implemented in Germany by the Act on protection of business secrets published on 18 April 2019.

As to the enforcement, trademark owners can obtain a preliminary injunction even without an oral hearing and within a very short time, but any delay in issuing proceedings can mean that this right may fall away. Both parties must be represented before the court by a German qualified lawyer.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

Unless the franchise is set up as pure online business, the franchisor should protect its interest in a strategic location of the franchise shop. If the franchisor owns or leases the shop, the termination scenarios of both the franchise and the lease or sublease contract should be synchronised. The downside of such scenario is that the franchisor bears the risk of non-payment of the lease. As an upside, the franchisor can clearly require the franchisee not to compete beyond the five-year limit of general EU competition law, as the limit does not apply if the franchisee (sub-)leased the premises from the franchisor (cf article 5.1 (a), 2 Vertical Block Exemptions Regulation; in all other cases, the franchisee may, nevertheless, according to case law, be subject to a non-compete obligation if it is necessary for the functioning of the franchise system). If, instead, the lease agreement is entered into by the franchisee with a third party, the franchisor usually requires to be granted a right of subrogation as lessee (to be contractually agreed upon with the lessor in the lease contract) in the event of termination of the franchise contract. This way the franchisor can ensure the continuation of the franchise personally or through another franchisee.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

Competition law (also known as antitrust law) consists both of EU and German laws. Basic principle: agreements or behaviour which have as their object or effect to appreciably restrict competition are prohibited (article 101 of the Treaty on the Functioning of the European Union (TFEU); section 1 Act Against Restraints of Competition). Franchise agreements are privileged: 'Provisions which are strictly necessary in order to ensure that the know-how and assistance provided by the franchisor do not benefit competitors do not constitute restrictions of competition' (Court of Justice of the EU, 28 January 1986, Case No. 161/84, *Pronuptia*, paragraph 27). This typically includes post-contractual non-compete obligations. In practice, many franchise agreements simply adhere to the requirements of the Vertical Block Exemptions Regulation (the current one expiring on 31 May 2022) to be on the safe side.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

German law does not provide a definition of franchise and neither does EU law (cf the report issued in 2016 by the Directorate-General for Internal Policies of the European Union on Franchising, p185; Kieran McLoone, Germany: The Self-Regulated Franchising Haven, in: Global Franchise, Issue 6.4 of 2021, p46). Nevertheless, there is a common understanding that the term defines the set of rights granted by a franchisor to a legally and financially independent and self-employed party, the franchisee, with the aim of a cooperative distribution system. A franchise entitles and obliges the franchisee, against a direct or indirect

financial compensation, to undertake, under the franchisor's supervision, the marketing system of goods, services or technology conceived by the franchisor (ie, the franchise system), which includes the franchisor's confidential know-how and ongoing technical and economic support, as well as the specific business concept and the intellectual and industrial property rights related to it.

Laws and agencies

13 What laws and government agencies regulate the offer and sale of franchises?

There is no specific German franchise law. Instead, the offer and sale of franchises are regulated by:

- the general good faith requirement, requiring a pre-contractual disclosure (sections 242, 311 BGB);
- the quite strict German rules on standard form contracts (sections 305–310 BGB), because franchise agreements are pre-drafted contractual rules provided by the franchisor for multiple franchisees; as a rule of thumb, the contractual rules need to be reasonable – and are void (not reduced to a valid minimum) if they unreasonably disadvantage the franchisee;
- the general requirements not to violate protective laws (section 134 BGB) or public policy (section 138 BGB);
- the statutory right of withdrawal if franchisees are natural persons to be qualified as founders of a business (section 491 et seq BGB; cf German Federal Court, 14 December 1994, Case No. VII ZR 46/94, Ceiling Doctor);
- the laws for commercial agents (section 84 et seq HGB) if the franchisees' interests are similar to those of a commercial agent (cf German Federal Court, 12 November 1986, Case No. I ZR 209/84, Beverage delivery service);
- the laws for commission agents (section 383 et seq HGB) may apply, especially if the franchisor aims to set the resale price;
- article 101 of the Treaty on the Functioning of the European Union (TFEU) and section 1 of the Competition Act (GWB) as regards restrictions on competition;
- the Act Against Unfair Competition (UWG) as regards advertising (unfair commercial practices – for example, misleading advertising – are illegal, and subject to claims for cease-and-desist, damages, confiscation of profits); and
- government agencies that regulate franchise business, which exist only in the form of competition authorities.

Principal requirements

14 What are the principal requirements governing the offer and sale of franchises under the relevant laws?

There is no specific German franchise law. Instead, the offer and sale of franchises are regulated by:

- the general good faith requirement, requiring a pre-contractual disclosure (sections 242, 311 BGB);
- the quite strict German rules on standard form contracts (sections 305–310 BGB), because franchise agreements are pre-drafted contractual rules provided by the franchisor for multiple franchisees; as a rule of thumb, the contractual rules need to be reasonable – and are void (not reduced to a valid minimum) if they unreasonably disadvantage the franchisee;
- the general requirements not to violate protective laws (section 134 BGB) or public policy (section 138 BGB);
- the statutory right of withdrawal if franchisees are natural persons to be qualified as founders of a business (section 491 et seq BGB; cf German Federal Court, 14 December 1994, Case No. VII ZR 46/94, Ceiling Doctor);
- the laws for commercial agents (section 84 et seq HGB) if the franchisees' interests are similar to those of a commercial agent (cf German Federal Court, 12 November 1986, Case No. I ZR 209/84, Beverage delivery service);
- the laws for commission agents (section 383 et seq HGB) may apply, especially if the franchisor aims to set the resale price;
- article 101 of the Treaty on the Functioning of the European Union (TFEU) and section 1 of the Competition Act (GWB) as regards restrictions on competition;
- the Act Against Unfair Competition (UWG) as regards advertising (unfair commercial practices – for example, misleading advertising – are illegal, and subject to claims for cease-and-desist, damages, confiscation of profits); and
- government agencies that regulate franchise business, which exist only in the form of competition authorities.

Franchisor eligibility

15 Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

German law does not provide eligibility requirements. However, self-regulatory rules exist, collected and laid down by the European Franchising Federation in its European Code of Ethics for Franchising and by its member German Franchise Association eV in their updated German version (Ethikkodex). Even if they only bind their members, these rules contain practical guidelines on best practice or fair dealings between franchisors and franchisees. Accordingly, the franchisor shall (1) have exercised the franchise concept already for a reasonable period with at least one pilot project; (2) be the owner or lawful authorised user of the franchise corporate identity (company name, trademark or other specific identification of its network), and provide both (3) initial and (4) follow-up trainings to the franchisees.

Franchisee and supplier selection

16 Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

No, there are no franchise-specific laws. In principle, franchisors are free to select their franchisees and their suppliers. Restrictions, however, may apply if the franchisor is a dominant undertaking or has relative or superior market power (which must not be abused, see article 102 TFEU and sections 19, 20 GWB) or pursuant to anti-discrimination laws (franchisors must not, generally speaking, discriminate on grounds of race or ethnic origin, sex, religion, disability, age or sexual orientation, cf sections 19-21 of the General Law on Equality (AGG).

Pre-contractual disclosure – procedures and formalities

17 What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

In Germany, there is no standard procedure. Case law (starting with the Higher Regional Court of Munich, 16 September 1993, Case No. 6 U 5495/92), requires the franchisor to disclose any circumstances which may affect the agreement's purpose within a reasonable period (two to four weeks may suffice) before concluding the franchise agreement (or any preliminary contract with binding effect, including area development franchise agreements or master franchises). For the sake of proof,

franchisors should make a disclosure in writing – also digitally, with special encryption and restricted access to protect business secrets.

Updating the disclosure may be necessary when the information provided becomes outdated before conclusion of the franchise agreement. For example, the franchisor is obliged to give an update if the turnover and revenue information changes: 'The defendant should have informed the claimant that the turnover development of the pilot operation was below the forecast, even if there were plausible reasons for this.' (Higher Regional Court of Cologne, 24 April 2009, Case No. 6 U 70/08, juris-para 23 'refilling of printer cartridges and cartridges').

Pre-contractual disclosure – content

18 What information is the disclosure document required or advised to contain?

The necessary information depends on the general principle of good faith. However, according to the prevailing legal opinion, the franchisor only has to inform about issues known to the franchisor, meaning that the franchisor does not need to perform researches for the franchisee as the franchisor is not obliged to provide services as a start-up consultant. The obligation is, instead, limited by the franchisor's legitimate interest in protecting its trade secrets and essential know-how prior to the conclusion of the agreement.

As first aid may serve the guideline published by the German Franchise Association eV on pre-contractual information and the – rather extensive – list in the UNIDROIT's Model Franchise Disclosure Law (not enacted in Germany, though). Circumstances to be disclosed include in particular the franchise system's:

- mode of operation (cf Higher Regional Court of Munich, 11 July 1996, Case No. 24 U 63/95);
- profitability/achievable turnover on the basis of generally applicable facts (cf Regional Court of Hamburg, 17 May 2018, Case No. 334 O 14/18);
- necessary labour and capital input (Higher Regional Court of Düsseldorf, 30 June 2004, Case No. U (Kartell) 40/02); and
- the advantages of cooperation within the franchise network, if applicable (eg, purchasing benefits, German Federal Court, 20 May 2003, Case No. KZR 19/02, *Apollo Optics*).

The information given – and answers to questions asked by the franchisee – must accurately reflect the realities of the franchise system in question, as the necessary basis for any suitable profitability forecast (cf also Higher Regional Court of Düsseldorf, 25 October 2013, Case No. I-22 U 62/13).

Pre-sale disclosure to sub-franchisees

19 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Within a sub-franchising structure, the sub-franchisor, as future contractual partner of the franchisee, must make pre-sale disclosure (cf section 311 BGB). Its extent depends on what the franchisee needs to know to decide about joining the franchise system. The information to be disclosed especially concerns:

- information about the franchise;
- how tasks are allocated among the franchisor (aka master franchisor), the sub franchisor and the sub-franchisees; and
- the basic content of the master franchise agreement, especially the licence, which allows and limits sub-franchisors installing of sub-franchisees and implementing of the franchise, including the consequences if the master franchise agreement is terminated.

Due diligence

20 What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

Franchisors should check whether the franchisee fits into the franchise system. To be more precise, this includes whether the franchisee is personally a good fit (characteristics, experience, abilities and ambition), and economically suitable (minimum capital requirements, territory available).

Franchisees should check the franchise system, its concept, the franchise agreement, the information disclosed pre-contractually, the competition situation, the territory and location.

Failure to disclose – enforcement and remedies

21 What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

Except in minor cases where they may simply ask for any missing or apparently inaccurate information, franchisees may do the following:

- terminate the franchise agreement for cause (section 314 BGB), within a reasonable period from having learned about such material breach of contract, typically two months (cf, for commercial agents and distributors: German Federal Court, 29 June 2011, Case No. VIII ZR 212/08). A prior warning is often not necessary, provided such event profoundly disrupts the trust between the parties;
- void the agreement if entered into by a mistake willingly induced by the franchisor (section 123 BGB); and
- claim damages.

The franchisee can demand to be placed in the same position he or she would have been in if the franchisor had not breached the disclosure obligation (section 249 BGB). Damages can be calculated by comparing the operating costs (system costs and rent/lease paid, insurance contributions, wages and social security contributions, costs for service providers) and losses in value (eg, the equipment, the warehouse) with the revenues. Alternatively, the franchisee can choose to rescind the entire franchise agreement retroactively if the franchisee would have not concluded the franchise agreement if the franchisor had duly informed the franchisee (cf German Federal Court, 27 July 2006, Case No. 23 U 5590/05, juris-paragraph 30). If the franchise contract is rescinded, all transactions will be reversed (ie, each party will return what it has received from the other). The worst-case scenario in practice is that such breach may induce further, not very successful, franchisees to terminate their franchise agreements.

Failure to disclose – apportionment of liability

22 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

In principle, liability for disclosure violations is not shared between franchisor and sub-franchisor, but the sub-franchisor alone will be liable towards the franchisee – because the disclosure requirement only exists within their relationship. By way of exception, the franchisor can be liable towards the sub-franchisee:

- directly in case of tort or product liability (eg, for providing defective products); or
- indirectly, namely when the franchisor is liable in regard to the sub-franchisor for breach of contract (eg, if the franchisor negligently provided incorrect information) and thus bears all consequential damages, including those the sub-franchisor has to bear due to the franchisor's breach of contract.

Individual officers, directors and employees of the franchisor or sub-franchisor are, in principle, exempt from liability for disclosure violations. By way of exception, they can be exposed to liability, especially if they have claimed a particular position of trust and expertise for themselves and then provided wrong information, and more so where this occurred with wilful intent and with the intention of causing financial loss.

General legal principles and codes of conduct

23 | In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

Offering and selling franchises must, like any other transaction, comply with the obligation of good faith, specifically under the principle of good faith in negotiation (culpa in contrahendo). Accordingly, pre-sale disclosure is mandatory as it may, if omitted or incorrectly done, allow the franchisee to reverse the whole franchise agreement. A guideline on pre-contractual information is provided at European level by the European Code of Ethics for Franchising and at national level by the German Franchise Association eV. Moreover, there is the – rather extensive – list in the UNIDROIT's Model Franchise Disclosure Law (not enacted in Germany, though). Circumstances regarding the franchise system to be disclosed include in particular:

- the mode of operation (cf Higher Regional Court of Munich, 11 July 1996, Case No. 24 U 63/95);
- the profitability/achievable turnover on the basis of generally applicable facts (cf Regional Court of Hamburg, 17 May 2018, Case No. 334 O 14/18);
- the necessary labour and capital input (Higher Regional Court of Düsseldorf, 30 June 2004, Case No. U (Kartell) 40/02); and
- the advantages of cooperation within the franchise network if applicable (eg, purchasing benefits, German Federal Court, 20 May 2003, Case No. KZR 19/02, *Apollo Optics*).

Fraudulent sale

24 | What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

Beyond the general remedies under civil law against missing or inaccurate franchise sales disclosure provided by a damage claim or a rescission of the contract, the franchisee may in the case of fraudulent or deceptive practices revert to the 'tools' of criminal law and criminal procedure: the franchisee may file a criminal complaint, thus having the law enforcement investigate the case, gather proof and potentially resulting in a conviction – which may serve as proof in the damages claims before the civil courts (sections 415 and 286 Code of Civil Procedure).

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 | What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There are no specific laws on the franchise relationship, and therefore it is best practice to regulate it in detail. When designing or developing the franchise system, the general rules of the German Civil Code (especially on standard form contracts: they need to be reasonable) and of the Commercial Code, the general good faith requirement and the competition (antitrust) rules must be observed.

Operational compliance

26 | What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

To ensure franchise compliance (ie, the franchisees operate a uniform network according to the corporate identity guidelines and deliver a consistent brand message and experience to the customers) franchisors use the following tools:

- clearly identify the standards;
- establish a contact person (franchise compliance officer or franchise compliance coordinator) dedicated to checking and clearing issues at the earliest convenience, and if not, enforcing the standards – and introduce that person to the franchisee;
- provide for regular reporting duties (eg, products sold or services rendered, monthly net turnover, etc), especially those items that are relevant for calculating the franchise fees;
- provide for inspection and audit rights, for the franchisor and third parties sworn to secrecy;
- underline the importance of compliance by stipulating contractual penalties or liquidated damages in the case of a breach; and
- reward the best examples among the franchisees ('franchisee of the year', etc).

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

Yes, provided that the franchise agreement contains valid 'change-of-terms provisions', especially to modify the relationship to develop the franchise system, the contractual products or the services and adapt to technological, legal or other changes. Such clauses are permissible and reasonable for the franchisee if they are sufficiently precise, stipulate the respective circumstances for change, adequately safeguard the interests of the sales intermediary and provide reasonable time before the change comes into effect (cf sections 310, 307, 308 No. 4 BGB; cf German Federal Court, 06 October 1999, Case No. VIII ZR 125/98 *Kawasaki*).

If, however, the franchise agreement does not provide a unilateral right to change the operational terms, the franchisor and franchisee remain, in principle, bound by the franchise agreement. By way of exception, the franchise agreement or its operational standards, or both, might be changed if the franchise agreement were otherwise frustrated (section 313 BGB).

Policy affecting franchise relations

28 | Do other government or trade association policies affect the franchise relationship?

The most important franchise association in Germany is the German Franchise Association eV, representing around 450 member companies at economic, political and social level. Those who wish to become members must comply with its code of ethics, stipulating practical guidelines of best practice and fair dealings between franchisors and franchisees and regulating issues such as pilot projects, rights of use regarding the corporate identity and training for the franchisees.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

If the franchise agreement is entered into for an unlimited period, it can be terminated with cause or without cause, namely ordinarily ('for convenience'), according to the terms stipulated in the agreement. In lack of such terms, the statutory provisions regarding commercial agents may apply by analogy (cf German Federal Court, 23 July 1997, Case No. VIII ZR 130/96, *Benetton*: likely, but not yet ruled out) as follows: one month's notice in the first year of contractual relationship, two months in the second year, three months in the third to fifth year and six months as of the sixth year. Fixed-term agreements, instead, can only be terminated for cause (ie, extraordinarily) with immediate effect, unless the parties specifically agreed on terms for ordinary termination. For the franchisor, such cause is typically, for example, the franchisee's non-payment of the franchise or advertisement fees, competitive practices, serious breaches of the franchise system directives or violation of the reporting and information obligations. Termination for cause, however, in principle requires sending the other party a warning first, since termination shall be the last resort (and hence default of payment alone does not necessarily suffice; cf Higher Regional Court of Berlin, 21 November 1997, Case No. 5 U 5398/97, *Burger King*). Finally, the parties can always agree on an amicable termination of the agreement. In very rare cases, the franchisor can also just let the franchisee's business run dry. However, to protect the franchisor's brand image and corporate identity, this option can be convenient only where the territory or the market are no longer relevant for the franchisor; for example, if the franchisor gives up the whole franchise.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

If the franchise agreement is entered into for an unlimited period, it can be terminated with cause or without cause ('ordinarily', or 'for convenience'), according to the terms stipulated in the agreement. Without such terms, the statutory provisions on notice periods regarding the commercial agent may apply by analogy: one month in the first year of contractual relationship, two months in the second year, three months in the third to fifth year and six months as of the sixth year. Fixed-term agreements, instead, can only be terminated for cause (ie, extraordinarily), with immediate effect, unless the parties specifically agreed on terms for ordinary termination. For the franchisee, such cause is typically, among others, the franchisor's breach of territorial exclusivity, reduction of the assigned territory agreed upon or direct supply in said territory. The parties can, of course, always agree on an amicable termination of the agreement.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

Renewals are usually effected in writing; typically, because this is required by the franchise agreement and because written agreements serve as proof of what the parties have stipulated. However, the parties may also renew the agreement tacitly, by simply continuing to perform it after its expiration date. Therefore, to avoid undesired results (eg, if there are ongoing negotiations with a new franchisee), the parties should cease trading on the date of effective termination.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Yes, in principle. The franchisor is free to either extend the franchise agreement or refuse to renew it, without requiring specific circumstances or reasons for its refusal. Nevertheless, further to the investment made in the franchise, the franchisee is entitled to a reasonable return and, at least, to recoup the resources invested. For this reason, if, shortly before the termination, the franchisor stated its intention to renew the franchise agreement, which led the franchisee to expend further resources in the franchise, the latter may be entitled to compensation for the damages suffered, in the event of a sudden refuse of the franchisor to renew the franchise agreement. Nevertheless, the franchisor's freedom to renew or not may be limited, especially when the franchisor has a dominant position on the market. If the franchisor has created trust in the franchisee that the franchise agreement will be renewed, a decision to the contrary may result in the obligation to pay damages or frustrated expenses for investments not returned.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes. The transfer of the franchise and of the rights and obligations connected therewith to a third party requires the franchisor's consent by law (section 415 BGB), regardless if it occurs in form of sale, lease, pledging or others. In lack of it, there is cause for extraordinary termination (cf German Federal Court, 26 November 1984, Case No. VIII ZR 214/83). Further conditions for the transfer, including the franchisor's pre-emption right, are usually – and are best – stipulated in the franchise agreement. A transfer of the franchise can also be contractually excluded, to protect the franchisor's know-how and image, especially from competitors. Exceptions may apply to the transfer of single rights, which are not characterised by personal features of the franchisee.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

No. The nature, amount and payment modalities of the franchise fees are subject to the contractual freedom of the parties. Nevertheless, the franchise fees cannot violate the general principles of public policy (section 138 BGB; for details on the franchisee fees to be stipulated under German law and an overview on fees required by different systems on the German franchise market, see Rohrßen, ZVertriebsR 2022, 139-151).

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

Interest rates must not be usurious, but comply with the general principles of public policy (section 138 BGB). As a rule of thumb, standard late payment interest rates amount to 5 per cent over the bank rate; nevertheless, the legal late payment interest rate in B2B transactions amounts to 9 per cent over the bank rate (section 288, paragraph 2 BGB). Regardless of the rate outcome, the creditor is also entitled to claim a lump sum of €40 as compensation for the payment delay (section 288, paragraph 5 BGB).

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No, there are no such restrictions. Nevertheless, any cross-border outgoing payment over €12,500 or the corresponding amount in the foreign currency must be reported to the German Central Bank (section 11 of the German Foreign Trade and Payments Act (AWG) in connection with section 67 and following of the German Foreign Trade and Payments Ordinance (AWV).

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Yes. Confidentiality covenants are a fundamental means of protection of the franchisor's know-how. A contractual penalty is generally agreed upon to deter and simplify the calculation of damages in case of breach. Moreover, the breach of confidentiality can also amount to an infringement of competition law and be regulated by the German Act Against Unfair Competition. Finally, non-compliance with the confidentiality obligation can justify termination for cause.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Yes. The parties' obligation to live an agreement according to the requirements of good faith is expressly set forth by section 242 BGB and sections 86 and 86a HGB. The good faith obligation typically requires franchisors to treat franchisees equally and to protect them, under very strict preconditions, from competition by other franchisees belonging to the same franchise system. Prerequisite for such an immanent obligation (and a corresponding contractual claim of the franchisee to injunctive relief) is that the economic existence of the franchisee is permanently endangered by the competing activity of the franchisor (Higher Regional Court of Düsseldorf, 10 February 2020, Case No. 16 W 62/11, juris, paragraph 39 *Kentucky Fried Chicken*; Higher Regional Court of Celle, decision of 28 August 2008, Case No. 13 U 178/08, juris, paragraph 15). If the franchise agreement qualifies as general terms and conditions (namely, if it was drafted unilaterally and offered to the counterparty on a take-it-or-leave-it basis), any provision contrary to the principle of good faith is void (section 307 BGB). Moreover, according to the case law, a breach of the obligation to act in good faith can be a cause for immediate termination of the franchise agreement (German Federal Court, 10 February 1993, Case No. VIII ZR 48/92, section IV.2(b) *Computer-Peripherie*).

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

In principle, no – franchisees fall under the category of businesses (section 14 BGB) and, therefore, cannot claim consumer rights (German Federal Court, 24 February 2005, Case No. III ZB 36/04). Nevertheless, the franchisee may, if considered as a founder, be entitled to withdraw from the franchise agreement within the first 14 days regardless of any reason. To limit such term, the franchisor must instruct the franchisee accordingly (typically within the franchise agreement or its annexes).

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

No, not by law. However, all documents should be in a language the franchisee understands, both for practical and legal reasons, as this avoids misunderstandings and disputes between the parties. It is also a requirement of the European Code of Ethics for Franchising issued by the European Franchise Federation. Moreover, the contractual language should ideally accord with the competent jurisdiction or arbitration's official language and with the law applicable to the franchise agreement. If the agreement is drafted in multiple languages, usually in a dual-column form, it is important to identify which language prevails in case of any discrepancy or dispute concerning meaning.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

Franchisors may limit the franchisees' economic freedom in several ways, typically by restricting the following elements:

- Territories, specifically by prohibiting active sales to exclusive territories (or customer groups), which the franchisor reserved for itself or allocated to another franchisee or other buyer. Limiting sales via the franchisee's website is, however, anticompetitive and such provision void and subject to fines by the competition authorities (cf on online sales bans and related internet resale restrictions, Rohrßen, *ZVertriebsR* 2019, 341 et seq with further references; example clauses of online resale restrictions in: Rohrßen, GRUR-Prax 2018, 39-41; on the new Vertical Block Exemption Regulation see Rohrßen, ZVertriebsR 2021, 293-298). Insofar, EU competition law forms one important (if not: the most important, cf. Flohr, ZVertriebsR 2022, 71, 74) block for building franchise agreements.
- Sourcing: franchisors may require the franchisees to source the contractual products or services from the franchisor. This is not a non-compete obligation in the narrow understanding of the Vertical Block Exemptions Regulation (VBER).
- Resale pricing: limited to imposing a maximum price or recommending a sale price, without any incentives or pressure.
- Poaching of the franchisor's or other franchisee's employees, to protect the franchisor's business secrets, especially where the franchisee after termination joins a competitor.
- Competition, through non-compete obligations during and after the term of the franchise agreement.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Franchisors can turn to the German courts for mediation (cf section 278 paragraph 5 and section 278a German Code of Civil Procedure)

and litigation. Litigation allows starting with interim injunctions to reach temporal results at an early stage. Also, an expedited payment procedure is available for cases where the franchisor does not expect the franchisee to reject a payment claim. Cases may also be dealt with in English, at the Chamber for International Commercial Disputes in Frankfurt am Main.

Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

The choice of the parties to apply a foreign law to their franchise contract is generally permitted, according to article 3 Rome-I-Regulation. However, German franchisors usually stipulate franchise agreements under domestic law because a different choice would be overridden by a large amount of national mandatory provisions (including the quite strict rules on standard form contracts). For an overview on the various levels of protection of franchisees in various countries worldwide, see Rothermel, *Internationales Kauf-, Liefer- und Vertriebsrecht* (2016), Chapter H.

Arbitration – advantages for franchisors

44 | What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

Principal advantages over proceedings in court

Arbitration proceedings are conducted as follows.

- they are held in any language agreed (while judicial proceedings in Germany are generally held in German);
- they are confidential (while German court hearings are open to the public, even if rarely well attended); and
- they are easily enforceable, compared to decisions of foreign courts outside the European Economic Area and Switzerland (cf section 1029 et seq German Code of Civil Procedure; New York Convention of 1958 on the Recognition and Enforcement of Arbitral Awards).

Principal disadvantages over proceedings in court

Interim measures may not be as quick as before German courts. Therefore, franchise agreements should at least stipulate that the German courts have jurisdiction where the franchisor's industrial property rights are infringed, thus enabling the franchisor to act quickly.

Costs are, as a rule of thumb until an amount in dispute of €5 million, higher than in German courts. The costs of arbitration may, however, be lowered by reducing the number of arbitrators from three to one; the arbitration clause may therefore provide for such reduction, especially with regard to smaller cases, where the amount in dispute is, for example, lower than €5 million (hence in the majority of disputes with single franchisees who do not also act as sub-franchisors).

Other ADR procedures available are through mediation or an ombudsman, which may be initiated through the German Franchise Association eV.

National treatment

45 | In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

None – legally, they are to be treated the same. Practically, franchisees may prefer binding themselves to and cooperating with domestic franchisors, as this simply feels 'closer to home'. For the franchisor, in return, establishing a company in Germany brings the franchisor in closer contact to the market, the franchisees, and helps to minimise the liability risk for the franchisor's principal company. Generally, domestic franchisors stipulate franchise agreements under German law – because even if a choice of a foreign law generally is permitted (article 3 Rome-I-Regulation), this choice would be overridden by a large amount of national mandatory provisions (including the quite strict rules on standard form contracts). For an overview on the various levels of protection of franchisees in various countries worldwide, see Rothermel, *Internationales Kauf-, Liefer- und Vertriebsrecht* (2016), Chapter H.

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UPDATE AND TRENDS

Legal and other current developments

46 | Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

As most recent legal development, on 10 May 2022 the EU has published the final version of the new Vertical Block Exemption Regulation (VBER) plus the accompanying guidelines (ie, the new EU Competition rules for all vertical agreements, including franchise agreements). As the VBER provides a safe harbour for vertical agreements, the VBER plus the related Vertical Guidelines are to be taken into account when setting up franchise systems. Generally, franchising is a different kind of animal compared to other kinds of distribution systems in terms of uniformity (business name and business methods are required for the functioning of franchising systems and thus, as far as necessary, fall outside the scope of article 101(1) of the Treaty; cf. Vertical Guidelines 2022, paragraph 166). Franchise agreements are exempt under the VBER as long as neither the franchisor's nor the franchisee's market share exceeds 30 per cent and the agreement is free from the hardcore restrictions set out in article 4 VBER. The basic rules that apply to franchise agreements under the new VBER insofar are very similar to the previous VBER of 2010. The new VBER, however, grants more leeway as regards protecting exclusive and selective distribution systems, while it provides more rules for online intermediation services. In case of dual distribution (ie, where the franchisor competes with its franchisees on the retail level through the franchisor's own operated stores), the strict rules on information exchange under article 2 (4) and (5) VBER 2022 need to be

observed: The exchange of information shall be directly related to the implementation of the vertical agreement and necessary to improve the production or distribution of the contract goods or services in order to be exempt. The Commission in the Vertical Guidelines (paragraphs 99 and 100) provides non-exhaustive lists of examples that are either likely or unlikely to fulfil these criteria. For an overview, cf Rohrßen, ZVertriebsR 2021, 293-298.

For the rest, no, there are currently no concrete proposals for regulating the franchising business in Germany. Instead, the most recent discussions, which reached the German Parliament in 2011 via a petition, have petered out. This is also due to the results of a comparative study on franchise laws that concludes that the German courts have established a rather clear case law that reduced the typical information disparity between franchisor and franchisees. This, again, resulted in relatively few issues reaching the courts, compared to other countries where statutory rules apply (Gesmann-Nuissl, Internationales Franchiserecht, 2019, p18) – and also compared to distribution systems that rely on other intermediaries, eg, commercial agents or distributors.

Since 2020, covid-19 has affected the German retail and franchise business. Franchisors have been since then forced to consider whether to permanently close down those shops where business is stagnant (especially those that were not thriving already before the pandemic). German law, however, adheres to the principle that agreements must be kept (pacta sunt servanda), and even the specific covid-19-laws do not simply allow tenants to terminate their lease contracts due to the crisis nor to suspend the lease payments. Instead, the tenant can withhold the rents for April, May and June 2020 until 30 June 2022 without the risk of the landlord terminating the lease for this reason, with the tenant in the case of a dispute having to prove that his or her non-payment is due to the pandemic. As this crisis especially affected – among others – the food service sector, McDonald's announced in May 2020, that it would back up its franchisees to protect the franchise network and cope with the reduced turnover, by either suspending or even waiving their monthly franchise fees for March and April and also planning an advertising offensive as the restaurants (not only the drive-throughs) were allowed to reopen in May in Germany.

Market trends indicate that there are particularly high chances for growth in the home services sector, education or training, skilled trades, and healthcare offer – including especially tech-related franchises, for example, electronic device repair, business tech consulting and digital marketing services.

India

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

With a population of approximately 1.35 billion people, India has one of the biggest franchise markets in the world. Several studies estimate that the market has been growing at a rate of over 30 per cent over the past five years. The current market is valued at approximately 3.5 trillion rupees and is expected to grow at a rate of over 25 per cent year-on-year, despite the covid-19 pandemic.

In India, franchising is common in the food and beverages, hotels, healthcare and wellness, and education sectors.

India does not have any franchise-specific laws or bodies to regulate franchise businesses and franchise agreements are mostly contractual in nature. Currently, there are no perceived regulatory or economic issues that impede the growth of franchises in India, although legislation applies to any business operating in India, including franchises. The Indian Contract Act 1872, the Foreign Exchange Management Act 1999 and the Income-tax Act 1961 are some of the main pieces of legislation that regulate franchise arrangements in India.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

Yes, there are several privately run franchising associations in India, membership of which is voluntary. The Indian Franchise Association and Franchising Association of India are two such associations.

The franchise associations primarily provide a platform for stakeholders to network and discuss issues facing the industry. Certain franchising associations also assist stakeholders in finance-raising, and provide market insights and business solutions.

Generally, each association has its own code of conduct or by-laws for its members.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

The choice of business entity relevant to a franchisor depends on the residential status of the franchisor.

A company established under the Companies Act 2013 (CA) or a limited liability partnership (LLP) established under the Limited Liability Partnership Act 2009 (the LLP Act) are the two most common forms of business entity used by Indian franchisors. An Indian franchisor may also conduct business by setting up a partnership firm under the Partnership Act 1932 or as a sole proprietorship firm. Several factors are considered when deciding on the form of business entity, including the need for external investments, ease of regulatory compliance and taxation.

It is not mandatory for foreign franchisors to form a business entity in India to grant franchise rights to Indian parties. Foreign franchisors can enter into a direct franchise agreement with Indian franchisees. However, some foreign franchisors prefer to establish an Indian entity for better management of franchise rights. The government's Foreign Direct Investment Policy (the FDI Policy) prescribes the forms of business entity that foreign parties can establish in India. Under the FDI Policy, a foreign franchisor may set up a company under the CA or an LLP under the LLP Act.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

The CA and the LLP Act govern the formation of companies and limited liability partnerships respectively. The Ministry of Corporate Affairs is the primary government agency responsible for administration of the CA and the LLP Act.

In addition to the CA and the LLP Act, the FDI Policy and the Foreign Exchange Management Act 1999 and its accompanying regulations are relevant as they prescribe the conditions for making foreign investments in India, including the forms of business entity that can be established.

Indian franchisors may also set up a partnership firm under the Partnership Act 1932, which governs partnership businesses in India.

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

Each form of business entity is governed by separate legislation that prescribes the specific requirements for forming and maintaining such an entity. For the purposes of this section, we will briefly discuss the

requirements for the incorporation of a private limited company in India, which is the most common form of business undertaking.

The CA regulates the incorporation of companies. There are different categories of companies, such as private limited companies, public limited companies and one-person companies. There could be further classifications within these categories depending on the liability of the company's shareholders.

At least two shareholders are required to set up a private limited company. The shareholders can be an individual or a body corporate. Furthermore, the CA requires a private limited company to have at least two directors, one of which must be an Indian resident.

The process for incorporation of a private limited company involves several steps, which include preparation of the by-laws (ie, articles of association (AOA) and the memorandum of association (MOA)), submission of applications to the Ministry of Corporate Affairs for reservation of name of the proposed company, grant of director identification number to the proposed directors of the prospective company, and submission of by-laws with the jurisdictional Registrar of Companies. The AOA contain the bye-laws of a company and the MOA provides for business objects, the authorised and paid-up share capital of the prospective company, and the shares subscribed by the initial shareholders of the company. The process for incorporation is exhaustive and several declarations and undertakings must be provided by the directors and shareholders of the prospective company. The declarations primarily relate to the directors' interest in any other business outside the company and any prior conviction of the proposed directors and shareholders in any offence in connection with the promotion, formation or management of any other company in India. It takes between 30 days and two months to form a company in India.

Once a company is established, it must comply with the CA, which, inter alia, requires a company to hold at least four meetings of directors and one annual meeting of shareholders in a fiscal year. All companies are required to maintain statutory registers, including registers of shareholders, directors, fixed assets, share transfers, directors' interests in other businesses, and the minutes of the directors' and shareholders' meetings. In addition to the CA, a company is subject to other legislation covering labour and employment, foreign exchange, indirect tax and income tax.

Restrictions on foreign investors

6 | What restrictions apply to foreign business entities and foreign investment?

The FDI Policy set out by the Department for Promotion of Industry and Internal Trade dictates the sectors that are open for foreign investments and the conditions subject to which foreign investments can be made in India, including the business entities that can be established by foreign residents in India. There are certain sectors that are prohibited from receiving foreign investments. These sectors include real estate, lottery and chit fund businesses. Although the government has liberalised the FDI Policy and most sectors are open for foreign investment up to 100 per cent without any need for prior government approval, there are certain sectors where prior approval is required. For example, government approval is required for foreign investments in a business operating in the defence sector when the overall foreign investment in the business exceeds 74 per cent. Similarly, any foreign investment in a multi-brand retail trading business requires prior government approval. There are certain sectors in which foreign investment is not permitted beyond a prescribed threshold, such as the print media sector and multi-brand retail trading, where foreign investment is capped at 26 per cent and 51 per cent, respectively.

The FDI Policy should be studied prior to making any foreign investments or setting up an entity to understand any restrictions that may be applicable to the proposed transaction.

Taxation

7 | What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

The Income-Tax Act 1961 (the IT Act) is the primary legislation on income taxes. The IT Act requires Indian franchisees to deduct the prescribed withholding tax on royalties, service fees and other payments to franchisors. Tax must be deducted before making any payments to franchisors.

The IT Act prescribes different withholding tax rates for different categories of services and these rates change from year to year.

India has signed double taxation avoidance agreements (DTAA) with various countries. Regarding payments to foreign franchisors, the IT Act provides that that withholding tax should be deducted at the rate prescribed in the IT Act or that of the DTAA of the home country of the foreign resident, whichever is more beneficial to the foreign resident.

Goods and services tax (GST), which is the primary indirect tax, applies uniformly across India. GST is applicable on royalties and service fees. In an arrangement where both the franchisor and the franchisee are Indian, the franchisor charges GST from the franchisee along with royalty or service fees, and subsequently deposits the GST with the tax department. However, in a cross-border franchise agreement between an Indian franchisee and a foreign franchisor, the foreign party is not required to charge or collect GST, but the Indian franchisee is liable to pay GST directly to the Indian tax department under the reverse charge mechanism.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

No, unless the franchisor establishes an entity in India and employs people directly. Typically, employment and labour laws do not apply in a franchisor–franchisee relationship. It is unlikely that a franchisee would be deemed an employee of its franchisor.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

There are various ways in which intellectual property (IP) can be safeguarded in India, with both common law and domestic legislation covering the protection and enforcement of IP rights. For instance, trademarks are protected under the Trade Marks Act 1999, and copyrights, patents and industrial designs have their own dedicated statutes. However, the Trade Marks Act 1999 does not formally define a licensee or a franchisee and franchisors are not required to register or disclose their licences under Indian trademark law. That said, the Trade Marks Act 1999 does provide for the recordation of a registered user, which is a party other than the brand owner itself authorised to use a registered trademark in India. The Trade Marks Act 1999 lays out actions for the infringement of registered trademarks and for the passing-off of unregistered marks under common law. Remedies for infringement and passing off typically include injunctions, damages, account-of-profits and search-and-seizure in anti-counterfeiting cases. Interestingly, in India, trademark infringement can be subject to both civil and criminal action.

There is currently no dedicated legislation for the protection of know-how. Instead, know-how and trade secrets are generally protected and enforced through contractual arrangements. A typical franchise agreement with an Indian franchisee should contain robust confidentiality obligations, as well as provisions setting out what constitutes the franchisor's trade secrets and the consequences

of their misuse. Separate non-disclosure agreements can also be considered during the process of vetting and negotiating with potential franchisees.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

Indian franchisors are free to either own or lease business premises. The property price or lease rent for business space varies from city to city depending on supply and demand.

The major legislation that regulates real estate transactions are the Transfer of Property Act 1882, the Registration Act 1908, the Indian Contract Act 1872, and state-specific stamp duty and rent control legislation. The law requires in most cases that real estate agreements be made in writing and registered with the local authority after payment of the appropriate stamp duty or tax.

In many franchise agreements, franchisors retain the right to acquire the assets of the franchise business upon termination of the franchise agreement. The Foreign Exchange Management Act 1999 and the regulations framed therein prohibit a foreign entity from acquiring any immovable property in India without setting up a local entity in India. A foreign franchisor that wants to acquire immovable property for the Indian franchise must establish a business entity in India.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

The Competition Act 2002 is the primary antitrust legislation in India. Although the Act does not have any express provisions in the context of franchisor–franchise relationships, it prohibits enterprises or persons at different stages of the production chain from entering into an arrangement for production, supply, distribution acquisition or control of goods, or the provision of services that will cause an appreciable adverse effect on competition.

Exclusive supply and distribution supply agreements, agreements for refusal to deal, or resale price maintenance between enterprises at different stages or levels of the production chain can be declared void when such agreements cause an appreciable adverse effect on competition in India.

The restrictions commonly imposed under a franchise agreement are not deemed anticompetitive per se if they are reasonable and aim to enhance the standard, efficiency and uniformity of a franchise system. However, the Competition Commission of India, on receipt of complaints, may examine the reasonableness of the restrictions contained in a franchise agreement on a case-by-case basis.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

There is no legal definition of a franchise under Indian law.

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

There is no law or government agency that regulates the offer and sale of franchises in India.

Principal requirements

14 | What are the principal requirements governing the offer and sale of franchises under the relevant laws?

There are no specific laws governing the offer and sale of franchises in India. The Indian Contract Act 1872 has provisions regarding the offer and acceptance of a contract in general and these would apply in respect of franchise agreements as well.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

No, Indian law does not prescribe any specific eligibility requirements that a franchisor should meet before offering franchises in India. Franchisors should meet the general requirements regarding competency to contract. The Indian Contract Act 1872 requires a person to be of sound mind, to be at least 18 years of age and to not be disqualified from entering into a contract under any other specific law of the land to which he or she is subject. Additionally, the contract should be made for a lawful consideration and lawful object, and with free will of the involved parties.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

No, Indian law does not prescribe any requirements relating to the manner in which a franchisor should recruit franchisees or select suppliers.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

Franchisors are not required to make any pre-contractual disclosures to franchisees or government agencies prior to the sale of a franchise in India. However, franchisors must not make false representations regarding the franchised business.

Pre-contractual disclosure – content

18 | What information is the disclosure document required or advised to contain?

Franchisors are not required to make any pre-contractual disclosures to franchisees or government agencies prior to the sale of a franchise in India.

Pre-sale disclosure to sub-franchisees

19 | In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

No such disclosures are required to be made to sub-franchisees.

Due diligence

20 What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

Although not mandatory, it is recommended that franchisors carry out proper due diligence on a prospective franchisee to ensure that it:

- meets the franchisor's eligibility conditions for the business in the relevant territory;
- has good standing and is legally compliant with applicable laws; and
- has adequate net worth to operate and scale the franchise business.

From the franchisee's perspective, it should be ensured that the franchisor is solvent and that there is no pending litigation or any adverse event that may affect business in the applicable territory.

Failure to disclose – enforcement and remedies

21 What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

Indian law does not require a franchisor to make any pre-sale disclosure to its franchisees or to any government agencies regarding the sale of a franchise business. However, if any false representations are made, the franchisee has the option of civil action and may claim damages.

Failure to disclose – apportionment of liability

22 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Indian law does not require franchisors or sub-franchisors to make any disclosure to sub-franchisees regarding the sale of a franchise business.

General legal principles and codes of conduct

23 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

There is no specific law in India that regulates the offer and sale of a franchise. The franchise arrangements are purely contractual. Under Indian law, a contractual arrangement must not be based on misrepresentation, fraud or undue influence.

Fraudulent sale

24 What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

Under the Indian Contract Act 1872, a franchisee that is subject to any misrepresentation, fraud or undue influence may set aside the franchise agreement and make a claim for damages.

The franchisee may also file a complaint against the franchisor for an offence of cheating under the Indian Penal Code where there is adequate evidence to prove that the franchisor acted fraudulently or dishonestly with criminal intent.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There is no franchise-specific law in India and franchisor–franchisee relationships are governed by the franchise agreement. In addition to the franchise agreement, involved parties are subject to a number of other laws, such as foreign exchange control regulations, antitrust laws, intellectual property laws, tax regulations, data privacy laws, and anti-corruption legislation.

Operational compliance

26 What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

Franchisors incorporate a number of provisions in the franchise contract to protect brand and quality standards and bring about uniformity in operational efficiencies. Such provisions include the franchisor's right to inspect the franchisee's business and premises, the right to audit the franchisee's books of accounts, conditions for the appointment of suppliers, and conditions that should be met prior to opening new locations.

Amendment of operational terms

27 May the franchisor unilaterally change operational terms and standards during the franchise relationship?

Under Indian law, a franchisor cannot unilaterally change operational terms and standards during the franchise relationship. Any change must be recorded in writing with mutual consent.

Policy affecting franchise relations

28 Do other government or trade association policies affect the franchise relationship?

The policies of trade associations do not affect the franchise relationship.

However, changes in government policy could have an impact on franchise relationships. For example, a change in tax policy or payment regulations may impact the franchise relationship.

Termination by franchisor

29 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

The franchisor–franchisee relationship is contractual and a franchisor can terminate the franchise agreement as per the agreement. Any termination of the franchise agreement outside the framework of the franchise agreement may be deemed a breach of the agreement.

Termination by franchisee

30 In what circumstances may a franchisee terminate a franchise relationship?

The franchisor–franchisee relationship is contractual and a franchisee can terminate the franchise agreement under the provisions of the agreement. Any termination of the franchise agreement outside the

framework of the franchise agreement may be deemed as a breach of the agreement.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

Because the franchisor–franchisee relationship is contractual, the terms for the renewal are usually provided in the agreement. In cases where a franchise agreement does not contain any provisions for the renewal of the agreement, both parties must mutually agree to renew the agreement. Substantive law does not prescribe any conditions for the renewal of agreements.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Many franchise agreements contain legally binding renewal provisions that require the franchisor to renew the agreement if the franchisee meets the renewal conditions. A franchisor can refuse to renew the franchise agreement when the agreement does not obligate the franchisor to do so or in cases where the franchisee has failed to meet the eligibility criteria prescribed for renewal of the franchise agreement.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes, a franchisor may contractually restrict its franchisee from transferring the business. The franchisor may also restrict the owners of the franchise entity from transferring their ownership interest in the franchise entity. Such restrictions should be unequivocally and expressly stated in the franchise agreement.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

Currently, Indian law does not regulate the nature or amount of fees that could be paid by Indian franchisees to their franchisors in India and overseas.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

Although there is no restriction on the amount of interest that can be charged on overdue royalties, the Reserve Bank of India (RBI) prescribes the maximum amount of interest that can be charged by a foreign party in respect of overdue service fees. The maximum interest rate that can be charged on overdue payments for services is the benchmark rate plus 300 basis points spread. The benchmark rate is the six-monthly London Interbank Offered Rate of different currencies or any other six-monthly interbank interest rate applicable to the currency of the transaction. The maximum permissible rate of interest is occasionally adjusted by the RBI and is therefore subject to change.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

The prevailing Foreign Exchange Management Act 1999 and its accompanying regulations and notifications do not restrict a franchisee from making payments to its foreign franchisor in the franchisor's domestic currency.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are generally enforceable, provided such covenants are reasonable and have a well-defined scope.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

The Indian Contract Act 1872 does not expressly incorporate the doctrine of good faith. However, some courts, for instance the Gauhati High Court in the case of *The Food Corporation of India and others v M/s Anup Trade And Transport (P) Limited and others* (Case No. WA 36/2020) have opined that every contract inherently includes the principle of good faith. Franchisors and franchisees should generally deal in good faith.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

The Consumer Protection Act 2019 (CPA) is the primary consumer protection legislation in India. The term 'consumer' as defined in the CPA expressly excludes persons who purchase goods or services for commercial purposes. Therefore, it is improbable that franchisees could be treated as consumers.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

There is no legal requirement for a disclosure document. Furthermore, the law does not require franchise agreements to be in a specific local language. The agreement can be drawn in any language mutually agreed on by the parties.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

The restrictions that are commonly imposed on franchisees are contractual in nature and include:

- restrictions on business activities outside the applicable territory;
- non-compete restrictions;
- confidentiality obligations;
- restrictions on transfer of ownership interest in the franchise entity;
- restrictions on transfer of assets and franchise business to a third party without first offering to the franchisor; and
- restrictions on the franchise to procure raw material from unauthorised vendors.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

India has a unified judicial system, with the Supreme Court at the top of the hierarchy followed by the high courts of each state. The district court is positioned below the state's high court and is followed by various subordinate courts. In addition to the regular civil courts, various tribunals (including appellate tribunals) have been set up for specialised matters, such as income taxes, debt recovery, intellectual property, and company law. Appeals from the orders of these tribunals lie with either the designated appellate tribunals, the state's high court or the Supreme Court, as the case may be.

Each court in India, except the Supreme Court, has a defined territorial limit over which it can exercise its jurisdiction. Furthermore, a pecuniary limit has been prescribed for all district and subordinate courts, and a court cannot exercise jurisdiction over a matter whose value exceeds the pecuniary limit set for that court. Generally, subject to the applicable pecuniary limit, a suit should be filed in the court that has jurisdiction over the place where the cause of the action arose, or where the defendant resides or carries on its business. Appeals from subordinate courts lie with the state's district court. Similarly, an appeal from a district court can be filed with the state's high court and then with the Supreme Court.

There is a huge pendency of cases in India. On average, it takes approximately five to seven years for the disposal of a suit by the original court and approximately three years in appeal cases.

Indian law does not prescribe a separate set of procedures for the resolution of franchise-specific disputes. If parties to a franchise agreement decide to resolve their dispute in Indian courts, then all such disputes will be resolved according to the Code of Civil Procedure 1908, which applies to all contractual and other civil cases.

Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

Although Indian law does not expressly prohibit a foreign franchisor from agreeing to a foreign governing law in a contract with an Indian party, Indian courts are not comfortable adjudicating disputes under such contracts due to their lack of familiarity with foreign law.

However, a foreign franchisor may opt for a foreign governing law should it decide to resolve disputes through arbitration seated in India or in a foreign country.

Arbitration – advantages for franchisors

44 | What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

Resolution of disputes in Indian courts is likely to result in a protracted litigation owing to a huge backlog of cases and slow disposal rates. Therefore, arbitration of disputes, as opposed to litigation in court, is preferred.

The Arbitration and Conciliation Act 1996 (the Arbitration Act) governs domestic arbitration, international commercial arbitration and the enforcement of foreign arbitral awards. The Arbitration Act defines an international commercial arbitration as an arbitration involving commercial disputes arising from a legal or contractual relationship between two or more parties, wherein one of the parties is a foreigner.

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The parties to an international franchise agreement may opt to arbitrate either in India or outside India in any country that is:

- a signatory to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards or the Geneva Convention on the Execution of Foreign Arbitral Awards; and
- notified as such by the Indian government.

There are no effective or binding alternative dispute resolution mechanisms in India other than arbitration.

National treatment

45 | In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Indian law does not treat foreign franchisors any differently from domestic franchisors. However, in cross-border franchise agreements, foreign exchange laws apply that may impose certain additional conditions and restrictions relating to payments, acquisition of assets by the franchisors in India, and establishment of an entity in India by foreign residents.

UPDATE AND TRENDS

Legal and other current developments

46 | Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

There are no significant current developments or proposals for revising existing legislations.

Israel

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Franchising is rather common in the Israeli market, especially in the food and beverage industry, and in merchandising, especially in the apparel and fashion industry. The Israeli market welcomes franchising, and there are no regulatory issues that have a negative effect on franchising relationships.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The Israel Franchise Promotion Centre, established in 2001, is a voluntary centre that promotes franchising in Israel. All members of the organisation are subject to an ethics code that aims to ensure the ethical management of franchise businesses. There is no membership requirement.

A few more institutes also promote franchising and provide services in respect of franchising.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

Most franchisors in Israel are incorporated companies (mostly private limited liability and domestic) or partnerships. Franchisors are rarely self-employed individuals.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

Business entities such as companies (including branches) or partnerships are formed under the Company Law 1999 or the Partnership Ordinance 1975, respectively, and registered in the respective register.

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

Establishing a business entity in Israel requires establishing a company (or partnership). Any international company wishing to conduct business in Israel should be registered either as a branch or by way of establishing a subsidiary. In any case a local address is required.

Upon commencement of its activity, the business should be registered with the relevant tax authorities. Maintaining a corporation is subject to annual fees and submission of annual reports approved by the company board of directors.

Under the Companies Law 1999, local Israeli companies and branches of foreign entities are under the obligation to appoint a certified public accountant (CPA) or an accounting firm serving as independent auditor. The CPA is appointed by the shareholders of the company in its annual general shareholder's meeting.

Restrictions on foreign investors

6 What restrictions apply to foreign business entities and foreign investment?

All foreign entities wishing to do business in Israel should establish a subsidiary or branch. Foreign entities are required to provide a local address. Foreign investments should comply with anti-money laundering regulations.

Unless dealing with defence or banking, there are no restrictions on foreign ownership of a business entity. Any foreign business entity or person starting to conduct business in Israel must appoint a local VAT representative whose permanent place of residence is in Israel and who assumes full responsibility for handling all value added tax (VAT) matters, if applicable.

Taxation

7 What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

Incorporated businesses are subject to regular income tax (corporate tax) imposed on taxable transactions. Certain transactions trigger payment of VAT.

As of 2018, Israel is party to over 50 double tax treaties, essentially following the OECD model. A foreign resident entity may be exempt from corporate tax to the extent that its activities do not constitute a permanent establishment under an applicable tax treaty. There is no detailed legislation or Israeli court decision that provides a clear test under which it is possible to determine whether a non-resident has a taxable presence under Israeli tax law; thus, where there is no tax treaty protection, a non-resident is subject to tax on income accrued or derived in Israel.

Tax is calculated based on the actual income of the business entity or person from its activity in Israel. Income tax is paid on an annual basis and may be subject to payments on account. VAT, when applicable, is paid on a monthly or bimonthly basis, depending on the scope of the transactions.

A branch of a non-Israeli entity is taxed in Israel on the profits the branch derives from its Israeli activities, while a local subsidiary is generally taxed on its worldwide income. The rate of income tax imposed on corporations in Israel is currently 23 per cent, and the Israeli profits of a branch are subject to that rate.

Social security payments are relevant to a business entity doing business in Israel and hiring personnel.

The Supreme Court held that payment of royalties or management fees by the franchisee to the franchisor will be considered as part of the purchase price of the goods and taken into account in calculating the custom fees due by the franchisee when those payments are a precondition to the purchase of the goods by the franchisee from the franchisor. This decision may affect the financial negotiations between franchisors and franchisees.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

Generally, a franchisor's employment relationship with its employees working in Israel is subject to Israeli law. Parties to an employment agreement may determine a different governing law; however, Israeli labour courts seldom apply foreign law when the law is less favourable to employees working in Israel than Israeli law.

As long as a clear separation between the franchisee and the franchisor is kept under the franchise agreement and is de facto, the risk that the franchisee's employees will be considered as the franchisor's employees is rather low. A franchise agreement should include a specific indemnification clause to reduce the franchisor's risk of being liable for any payments to the franchisee's employees.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

Any domestic or foreign franchisor may apply to register its trademarks for goods and services with the Israeli trademark office to ensure its exclusive right to use it. The trademark registration is valid as long as it is used in Israel.

The licence granted to the franchisee to use the franchisor's trademarks should be recorded with the Trademark Register for validation and to ensure that use of the trademark by the franchisee is attributed to its registered owner.

The Trademarks Ordinance also provides for the enforcement of non-registered trademarks. Know-how is protected as either a patent (provided it is patentable and registrable) or a trade secret under the Commercial Torts Law 1999. For the sake of enforcing the protection, the know-how should be kept a secret. Once it reaches the public domain, the know-how is no longer protectable. It is advisable to address the matter of domain name (.il) allocation as part of the franchise agreement.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

There are no legal restrictions relating to foreign or domestic franchisors in respect of purchasing or leasing real estate.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

Competition in the Israeli market is regulated under the Commercial Competition Law 1988 (formerly known as the Restrictive Trade Practice Law). Franchise agreements are exempted from the prohibitions under the Law in accordance with a specific block exemption unless the parties to the agreement are actual competitors; a party has monopoly power in the relevant product market or in an adjacent market; or the agreement's duration is 10 years or longer.

Franchise contracts, which are covered unless the franchisee's market share exceeds 30 pe cent, can control resale prices without restriction and may also restrict the franchisee from engaging in active sales promotion outside the assigned franchise territory.

The block exemption on franchise agreements protects ancillary restrictions included in a franchise agreement, provided that the restrictions are required for the realisation of its objective and do not cause substantial harm to competition.

The block exemption on franchise agreements further disqualifies certain terms barring the franchisee.

The Israel Competition Authority oversees enforcement of the law when it is violated. The enforcement proceedings begin with an investigation, which may lead to financial sanctions or criminal charges.

The franchise agreement should be carefully drafted to comply with the exemption for franchise agreements.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

There is no specific legislation regulating franchises in Israel. The only definition of 'franchise agreement' in Israeli legislation can be found in regulations enacted under the Commercial Competition Law 1988, which provide a block exemption to franchise agreements under certain circumstances. The definition in the regulations is as follows:

> *'Franchise Agreement' a contract under which a franchisor grants the franchisee the right to use the franchise for the purposes of marketing certain goods or types of goods, including each of the following:*
>
> *(1) use of a uniform trade name or trademark or service mark, and uniform characteristics of the goods being sold or of the sale and execution, which are material to the marketing and sale of the goods;*
>
> *(2) transfer of knowledge from the franchisor to the franchisee which is material to the marketing and sale of the goods;*
>
> *(3) commercial or technical assistance from the franchisor to the franchisee, during the term of the agreement.*

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

Israel has no specific laws or regulations for franchises. Franchises in Israel are regulated under contract laws, intellectual property laws and commercial competition law, as well as case law. No government agency regulates franchises in Israel.

Franchise agreements may be exempted from the Commercial Competition Law 1988 under a block exemption and are, thus, not

considered restrictive arrangements banned under the Law, provided that the agreements comply with the requirements in the rules for franchise agreements.

The exemption under those rules will not apply where:

- the parties to the agreement are actual competitors;
- a party has monopoly power in the relevant product market or in an adjacent market;
- the agreement's duration is 10 years or longer, or;
- when the agreement includes restrictive stipulations, such as:
  - restriction of the franchisor from using licensed know-how after the term of the agreement, even when the know-how is in the public domain;
  - prevention of the franchisee from initiating judicial review of the validity of the rights in know-how transferred from the franchisor to the franchisee or other intellectual property rights;
  - prevention of the franchisee from selling or supplying goods to consumers outside the territory defined in the agreement; and
  - other restrictions that are only meant to reduce competition or are not necessary to fulfil its principal.

The Commercial Competition Law 1988 deems arrangements whose restrictions involve the right to use a patent, trademark, copyright or proprietary right as not restrictive, provided that the arrangement is made between the owner of the right and the party who receives authorisation to use the right and where the right is subject to registration by law and is registered accordingly.

Principal requirements

14 | What are the principal requirements governing the offer and sale of franchises under the relevant laws?

Not applicable.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

There are no such requirements or guidelines.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

There are no specific rules or laws for franchisee selection unless the franchisor is a local government or public body subject to the Mandatory Tender Act 1992.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

There are no requirements in respect of pre-contractual disclosure except under the general contract law, which requires that the parties negotiate in good faith. There is no specific requirement for updating the disclosure, except if the requirement derives from the duty of the parties to act in good faith for the duration of the agreement.

Pre-contractual disclosure – content

18 | What information is the disclosure document required or advised to contain?

Under general contract law, each party is under the duty to disclose information, the non-disclosure of which might be considered as bad faith or might mislead the other party. When a due diligence process is initiated, all questions posed should be responded to in full transparency.

Pre-sale disclosure to sub-franchisees

19 | In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

There is no specific rule except the requirement to negotiate in good faith. It is advisable to include in the franchise agreement terms and conditions that should be included in sub-franchising contract.

Due diligence

20 | What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

Customary due diligence should, as in any other transaction, be undertaken.

Before starting to use a new brand in the Israeli market, parties should clear their right to do so, given that under Israeli law, a person may accrue rights in a trademark through use and be entitled to protection, even if the trademark is not registered. Thorough research of the market should be performed before establishing franchises in the market; a search in the database of the Trademark Register alone is not sufficient.

Failure to disclose – enforcement and remedies

21 | What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

Breach of the duty to disclose under the general duty to act in good faith during the pre-contractual period and negotiations entitles the franchisee to damages. The damages are usually punitive, calculated based on the actual loss incurred by the franchisee owing to the negotiations (including full reimbursement of costs); however, in extreme circumstances, such as gross bad faith or intentional deceit, the courts may consider awarding reliance damages calculated on the basis of the expected gain of the franchisee had the agreement been executed.

Failure to disclose – apportionment of liability

22 | In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

The response to this question depends on the parties involved in the negotiations of a sub-franchise agreement. If both the franchisor and the franchisee participate in the negotiations, both are under the duty of good faith; thus, if that duty is breached, each of the parties will bear responsibility.

If the share of each of the parties may not be determined, the liability will be borne by both in equal share. Where the franchisor and

the franchisee are legal entities, their representative will bear liability in respect of fraud or wilfully misleading acts.

General legal principles and codes of conduct

23 | In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

The duty of good faith during negotiations, the *culpa in contrahendo* principle, is applied under the Contract (General Part) Law 1973. The Law does not prescribe the extent of disclosure and requires each negotiating party to act in a 'customary manner' and in good faith, thus leaving it to the courts to decide.

The Standard Contract Law 1982 applies when franchisors act under standard agreements. Pursuant to this law, the court may find certain terms to be unreasonable practice, unfair or oppressive. The Law further allows franchisors to seek advance approval of its standard agreement. The approval serves as a declaration that the standard terms are not oppressive.

Fraudulent sale

24 | What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

Given the lack of specific legislation in respect of franchise agreements, a franchisee is considered in the same way as any other party to a contract facing fraudulent or deceptive practices in the framework of negotiations. The law provides for reliance damages; however, in some extreme cases, the Israeli courts have granted performance damages.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 | What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There are no specific laws; however, the Israeli courts regard the franchisor-franchisee relationship to be a trust-based relationship and, therefore, rarely enforce the relationship where a loss of trust transpires between them.

Operational compliance

26 | What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

Where the franchise agreement provides for royalty payments (rather than the case where the franchisee is reselling the franchisor's goods), it is common to require periodic reports and to allow the franchisor to audit the franchisee's business and inspect its books, especially if the royalties are calculated based on the income of the franchise or any other measurable volume of activity. The franchisor is further entitled to inspect the way its intellectual property is used by the franchisee and compliance with its code and standards.

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

It depends on the agreement between the parties. Unilateral changes in the agreement terms without a proper mechanism that has been agreed is usually not recognised under Israeli law unless the change is for the benefit of the franchisee.

Policy affecting franchise relations

28 | Do other government or trade association policies affect the franchise relationship?

No.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Termination of a franchise agreement is subject to specific stipulations agreed to by the parties. Under Israeli contract law, any party may terminate an agreement in the event of material breach of the agreement subject to certain conditions. An agreement may be terminated if the franchisor was misled by the franchisee in negotiations, and the franchisor may prove that but for the misleading information it would not have entered into the agreement.

Where the agreement is unlimited in duration, any party may terminate subject to reasonable prior notice or any other condition deriving form the agreement between the parties, such as reimbursement of investment and repurchase of stock.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

In the same circumstances as applicable to the franchisor.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

No formal requirements apply. It is advisable to renew agreements in writing for evidential and certainty purposes.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

The response depends on the franchise agreement. If the agreement does not provide for renewal, any party may refuse to renew.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Such restriction is allowed (and customary), especially given the fact that Israeli courts consider the franchisor-franchisee relationship to be based on party trust.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

No. It is advisable to consult a local certified public accountant for that matter.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

No, except that the courts have the discretion to lower unreasonable charges, even if the charges were agreed by the parties.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No; however, all payments should comply with the anti-money laundering regulations applicable to banks in Israel.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Yes, as long as the information covered may be regarded as a trade secret as defined in the Civil Torts Law 1999.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Yes. Bad faith may be regarded as breach of the franchise agreement, thus allowing its cancellation under certain conditions.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

No. Under the Defective Products Law 1980, a strict liability standard is imposed on the manufacturer, importer, seller and distributor in respect of personal injury resulting from a defective product. The liability should be covered in the franchise agreement, as should the product liability insurance and its costs.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

There is no such demand; however, the language of the agreement should be understood by both parties in order to estop any argument based on misunderstanding of the stipulations of the agreement.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

It is customary to include in franchise agreements restrictions such as

- exclusive territories;
- restrictions on sources from whom a franchisee may purchase or lease goods or services (restrictions on the purchase of goods and services from other franchisees of the same franchisor or restrictions on the source of goods, even if those in line with the franchisee's business are forbidden under the block exemption of franchise agreements);
- restrictions on the customers to whom the franchisee is entitled to sell the franchisor's products or services;
- restrictions on advertisement of the goods or services;
- prohibition on franchisees soliciting the franchisor's or other franchisees' employees;
- non-competition;
- confidentiality;
- governing law;
- dispute resolution;
- audit rights;
- insurance;
- indemnification obligations;
- allocation of the goodwill accrued through the use of the brand by franchisee to the franchisor;
- restriction on the use of intellectual property assets other than in accordance with the license granted under the agreement (eg, restriction to apply for the registration of the trademarks owned and used by the franchisor or any confusing similar trademark restriction on allocation of domain name using the brand or any part thereof);
- assumption of full liability to the franchisee's employees by the franchisee; and
- post agreement restrictions relating to the use of franchisor's intellectual property.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Israeli courts were established under the Basic Law: the Judiciary, under which a single system of courts of law exists. The courts of law include the Supreme Court, five district courts and magistrate courts (acting as first instance for most cases in Israel).

There are also courts for traffic offences, family courts, juvenile courts and national and regional labour courts.

The courts are independent and constitute a separate unit under the Ministry of Justice.

Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

There is no restriction on applying foreign law in an Israeli court; however, the foreign law should be proved as any other fact (by way of expert opinion). The Israeli courts usually respect foreign governance of law agreed by the parties unless there are reasons not to respect such choice on the ground of public policy. Where foreign governing law is agreed between the parties, the substantive foreign law will be applied rather than the procedural law.

Arbitration – advantages for franchisors

44 | What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

Arbitration is common in franchise transactions in the Israeli market. The advantages of arbitration are:

- the freedom of the parties to choose their arbitrator;
- the possible efficiency of the process; the freedom of the parties to agree that the arbitrator will not be bound by procedural regulations or local evidence law;
- the freedom of the parties to agree that the decision is final and may not be appealed; and
- the freedom of the parties to set in advance the venue and the language of the process.

The disadvantages are:

- the cost of the proceedings, given that the parties should bear the fees of the arbitrator (subject to its final decision);
- the limited enforceability of orders issued by the arbitrator granting interim relief (although the district court is authorised to provide such relief under specific circumstances); and
- the fact that the decision may not be appealed unless the parties agree otherwise (even then, the grounds of appeal are rather limited).

It is advisable to consider business mediation before turning to arbitration or court proceedings.

National treatment

45 | In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Domestic and foreign franchisors are treated equally by the Israeli legal system.

UPDATE AND TRENDS

Legal and other current developments

46 | Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

During the past two years, there have been no major developments in the field of franchising, despite an apparent initiative of the bar association in 2008, which did not mature.

* *The information contained in this chapter is accurate as at 20 July 2021.*

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Franchising is an important instrument that has, in recent years, increased its importance in Italy with an annual increase of between 1.6 per cent and 2 per cent. This trend has continued during the covid-19 pandemic, in which franchising has proven to be particularly resilient and able to better face hardship. According to numbers published by Assofranchising in 2020 (the 2021 figures are yet to be published), in Italy, almost 1000 franchising networks that can be considered active (ie, with at least three sales points) are present. The majority of them are represented by Italian brands (almost 89 per cent) while the rest can be traced back to foreign franchise networks that operate either through a domestic master franchisor or only through franchisees. Within this spectrum, the food industry plays an important role; the number of restaurants and bars opened under franchise systems in 2018 increased by 20 per cent compared with 2017. Other sectors in which franchising is common are real estate and brokerage activities, education, gyms, beauty services, and sale of general goods to consumers.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

There are two franchise associations considered to be the most important in Italy. The first is the Italian franchising association Assofranchising, which was founded in 1971 and, according to own figures, has over 200 franchisor member brands that generate a turnover of over €6 billion through their respective franchise networks. The second is the Italian franchising federation Federfranchising, which belongs to the network of Confesercenti, which is one of the main business associations in the country. Confesercenti represents 350,000 small and medium-sized enterprises in the tourism, trade and services sectors, which are in turn grouped into 70 trade associations (of which Federfranchising is one). Both associations promote franchising in Italy and participate in the legislative process as groups of interest. Important regional and national events are regularly organised by both organisations, such as Assofranchising's annual Salone Franchising event, in which domestic and international franchisors and franchisees, as well as external experts and consultants, meet to discuss topics and trends of franchising.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

Like most jurisdictions, Italy recognises business entities with limited and unlimited liability. The former is preferred in common commercial practice, particularly among franchise businesses, as it protects shareholders from general business risks and allows for a better allocation of funds.

Depending on the size of the proposed business, the relationship between shareholders and the types of investment, franchisors typically choose between a company limited by shares (SpA) or a limited liability company (Srl).

An SpA is more suitable for major franchise businesses because this type of entity offers more options regarding:

- shareholder agreements;
- the issue of debt notes;
- the allocation of assets for particular corporate purposes; and
- stock listing.

An Srl is more cost-efficient and suitable for small and medium-sized businesses since as this entity permits, among other things:

- greater shareholder control of the company's management;
- a stricter link between shareholders; and
- a more flexible management and shareholders' meeting system.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

Both SpAs and Srls are governed by the Italian Civil Code, which provides all relevant legal provisions for the formation of such business entities. Special rules govern the mandatory registration of companies in the register of undertakings held by the relevant chamber of commerce.

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

Companies (both SpAs and Srls) are incorporated by means of a deed of incorporation, which also includes the relevant by-laws. With some differences between SpAs and Srls, the deed must contain all relevant information as to:

- the company's name and place of business (municipality only);
- the scope, amount and allocation of share capital;
- the shareholders' meetings; and
- the management rules.

The minimum share capital amounts are €50,000 for an SpA, €10,000 for an ordinary Srl and between €1 and €9,999 for a simplified Srl or an ordinary Srl with reduced share capital.

For the incorporation procedure to be effective and a company to acquire legal status, the deed of incorporation and by-laws must be converted into a public deed by a notary public and be registered with the register of undertakings. It costs approximately €2,500 to form an Srl and €5,000 to form an SpA. Usually, the registration procedure can be completed within five to seven days from the execution of the incorporation deed.

The maintenance of a business entity mainly requires payment of annual fees at the Chamber of Commerce (which depend on the annual turnover), the preparation of mandatory company books, bookkeeping and filing annual tax declarations.

Restrictions on foreign investors

6 | What restrictions apply to foreign business entities and foreign investment?

In principle, no significant restrictions apply to foreign business entities and foreign investments. Where a foreign business entity engages in active business in Italy, it may be required or appropriate for it to register as a branch with the Italian register of undertakings, obtain a tax number for doing even the simplest transaction, or both. Some restricted business activities – generally those with a high level of public interest, such as companies in the banking and finance, transportation, energy, and food and drugs sectors – may require special licences from the relevant agencies.

With regard to foreign investment, foreign investors may face difficulties when trying to acquire company participations or merge with Italian companies involved in certain specific core businesses (eg, the automobile, energy or banking industries) given the potentially protective attitude by national or local authorities. Recently, in the context of the covid-19 pandemic, the Italian government has widened the application of the 'golden power' for specific strategic industries including energy, transports, public media, food safety and health etc, which authorises the Italian government to block transactions concerning control of relevant companies or to provide specific provisions.

Taxation

7 | What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

The Italian tax system provides the following:

- Corporate income tax at a flat rate of 24 per cent.
- Regional tax on business activities, which is a local tax applied to the value of the production generated in each taxable period by persons carrying out business activities in an Italian region. The standard tax rate is set at a minimum of 3.9 per cent. Regions may increase or reduce the standard tax rate by up to 0.92 per cent.
- Value added tax (VAT), generally charged on any supply or service deemed to be made or rendered within Italy. The ordinary VAT rate is 22 per cent.
- Withholding tax (WT) on royalties, at a rate of 30 per cent (section 25(4) of Presidential Decree 600/73).

With regard to the taxation of foreign franchise businesses and individuals, a preliminary investigation into whether the payments qualify as royalties or services rendered within the franchise agreement must be performed, as the relevant tax treatment from an Italian perspective is different from other jurisdictions. This qualification must be assessed on a case-by-case basis, depending on the agreement and the relevant circumstances.

Should the payment be deemed a royalty, all fees paid in connection with a franchising agreement are taxed on the non-resident franchisor in Italy for its Italian source of income.

An Italian entity subject to WT must file a certification of the WT paid on behalf of the recipient, so that the recipient can use such document to obtain tax credits, if available, in its country of residence.

Further, royalties paid by a resident corporate business entity or a commercial public or private entity to a company or a permanent establishment resident in an EU member state other than Italy are tax exempt, provided that certain subjective and participation conditions are met. As to the latter, the exemption applies if:

- the paying company holds at least 25 per cent of the voting rights in the company receiving the payment;
- the recipient company holds at least 25 per cent of the voting rights in the paying company; or
- a third company directly holds at least 25 per cent of the voting rights in both the paying company and the receiving company (section 26quater of Presidential Decree 600/1973).

Conversely, should the initial and service fees be qualified as services rendered outside Italy, such income would not be subject to any tax in Italy, including WT, provided that the recipient does not have a permanent establishment in Italy.

From a VAT perspective, as per sections 7ter and 17 of the VAT Law (Presidential Decree 633/72), even if the franchisor is not an EU-based company, as the service or royalty is related to the Italian activity carried out by (or licensed to) a resident franchisee, the VAT on the relevant payments is due in Italy on the basis of the reverse charge mechanism. Should the non-resident franchisor be an EU-resident entity, the franchise system may be exempted from the application of VAT on the basis of the same mechanism.

Individuals

As a general rule, non-resident individuals are taxed only on income generated in Italy. An individual is considered resident in Italy for tax purposes if for the greater part of the fiscal year (ie, more than 183 days) the individual:

- is registered with the Registry of the Resident Population;
- has a residence in Italy; or
- has a domicile in Italy.

In Italy, individuals are subject to:

- personal income tax (between 23 and 43 per cent);
- an additional regional tax (between 0.9 and 1.4 per cent);
- an additional municipal tax (between 0.1 and 0.8 per cent); and
- a regional tax on business activities (which applies to individuals who have their own VAT position and are resident in Italy).

In the case of individuals with a VAT position, a favourable tax regime was recently implemented, under which a flat personal income tax of 15 per cent applies up to the personal income threshold of €65,000 per year and under the condition that further circumstances are met.

Non-resident individuals are subject to tax on income generated in Italy. According to section 23.2(c) of Ministerial Decree 917/1986, remuneration deriving from the use of intellectual property, processes, formulae, and industrial and commercial information in connection with know-how are deemed as generated in Italy if they are paid by the state, entities resident in the state or permanent establishments of non-resident entities. Such income is subject to a 30 per cent WT under section 25(4) of Presidential Decree 600/73. A tax treaty against double taxation may provide more favourable tax rates.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

In principle, under a typical franchise structure, the franchisee is an independent entity or individual undertaking and bears its own entrepreneurial risk. Thus, even if the franchisor has its own standards to be applied by the franchisee and its employees, provided that no direct control, advice or subordination on the franchisee's employees is performed by the franchisor, there should be no concerns regarding the franchisor being deemed the employer of the franchisee or its employees. In the case of franchisees incorporated as unlimited liable companies, possible risks should be verified on a case-by-case basis, and be considered accordingly in the franchise agreement and its attachments.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

Trademarks are protected in Italy by means of registration with the Trademarks and Patents Office or, with regard to EU or international trademarks, through registration with the Office for Harmonisation in the Internal Market and the World International Property Organization.

Trademarks are regulated by the Industrial Property Code, which was enacted in Italy by Legislative Decree 30/2005.

A duly registered trademark provides the owner with exclusivity rights for 10 years starting from the date of filing the registration request. The owner of a registered trademark has the right to its exclusive use, as well as the right to ban any third parties from using it.

Know-how and trade secrets are expressly recognised in sections 98 and 99 of the Industrial Property Code.

As for protection, the law provides for action where know-how and trade secrets are communicated to third parties, or obtained in an illegal or inappropriate manner. Know-how and trade secrets are generally protected by rules on unfair competition.

To be eligible for protection, know-how must be secret, carry economic value through its secrecy and be kept by the owner in a proper manner to maintain its secrecy.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

Real estate transactions and issues may be crucial to franchisors, particularly where a franchise relationship is connected with a real estate development agreement and real estate finance (this is typical in the hotel and food industry franchise business). This is the case even with smaller and medium-sized franchise businesses, where the franchisee must comply with the franchisor's standards.

In Italy, real estate is expensive compared with other countries. However, prices differ depending on whether it is located in a major city and in a central area or in smaller cities.

Real estate law is governed mainly by the Italian Civil Code with regard to ownership, while lease agreements are regulated by the Italian Civil Code and specific laws (in particular the Commercial Lease Law No. 392/1978). Specific legislation regulates all relevant administrative town planning issues.

The lease of real estate for commercial purposes must cover a period of at least six to nine years for hotels and similar businesses. Restrictions may apply on automatic renovation after expiration. Renewal cannot be denied upon the first expiration unless the owner can show specific needs as set out in the applicable laws. Commercial lease law provides the possibility for the tenant to withdraw for extraordinary reasons with a six-month notice period. Parties are free to agree on further withdrawal rights. The possibility to rebalance the economic conditions of the lease agreement in case of extraordinary events that impact the business of the tenant (such as, for example, the covid-19 pandemic) must be assessed unless not regulated in the contract, according to the general principles of the Italian Civil Code in relation to force majeure. Further to this, there have been numerous decisions in the Italian courts that have not produced a unanimous opinion on the right of the lessee to rebalance the contract.

It is common practice for landlords that own or manage big commercial infrastructures (such as outlets, airports, train stations, etc) to lease the premises for commercial activities not via an ordinary lease agreement according to commercial lease law (which is more protective of tenants) but with a lease agreement over a business that requires appropriate attention during the relevant negotiations.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

There is no specific competition law regarding franchisees, although the general EU provisions on this must be considered. In brief, the consolidated versions of the Treaty on the European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU) provide for specific rules on competition and, specifically, on vertical agreements and the restraints deriving from the execution of them.

Article 101 TFEU expressly prohibits agreements that may affect trade between EU countries and that prevent, restrict or distort competition. Included among the practices prohibited and referred to under article 101 TFEU is the fixing, either directly or indirectly, of the purchase or selling prices or any other trading conditions, inter alia. Pursuant to article 101, paragraph 2 TFEU, any vertical agreement (prohibited under article 101, paragraph 1 TFEU) is considered automatically void. Despite this, the agreements, which create sufficient benefits to outweigh the anticompetitive effects, are exempt from this prohibition under article 101, paragraph 3 TFEU. With the Commission Regulation No. 2790/1999 of 22 December 1999 (L 336/21) (the Regulation), the European Commission issued new legislation aiming to implement the aforementioned exception for vertical agreements. The Regulation introduced a new principle of balancing the anticompetitive effects of vertical agreements with their benefits, if any. Upon expiration of the Regulation (31 May 2010), on 23 April 2010, the European Commission issued Commission Regulation No. 330/2010 (the New Regulation). The New Regulation, as did the Regulation, concerns the applicability of article 101, paragraph 3 TFEU to vertical agreements.

While no maximum term is provided by the applicable law for the duration of a franchise agreement (which can have an open or a limited term), it must be noted that according to article 3.3 of Act 129/2004 (the Franchising Act), if the agreement is for a limited term, the franchisor must guarantee the franchisee a minimum term related to the period of amortisation of the franchisee's investments. This term must not be less than three years, except in cases of early termination for breach of contract by one of the parties.

The non-compete clause does not represent an essential element of the franchise agreement; therefore, if it is not expressly provided for in the contract, it will not operate between the parties. The non-compete clause is governed by article 2596 of the Italian Civil Code, which provides that such an agreement may have a maximum duration of five years and must be limited in time or to a specific activity or area. However, according to the prevailing case law, article 2596 of

the Civil Code does not apply to agreements between entities operating at different levels of the line (so-called vertical agreements), as is the case for franchises. Consequently, a non-compete clause included in a franchise agreement is not subject to the limits provided for by article 2596 of the Civil Code. Consequently, in principle, the involved parties (and the franchisor) are free to regulate the non-compete clause in the contract if preferred.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

'Franchising' is defined in Act 129/2004 (the Franchising Act) as a particular kind of agreement between two separate entities – one of which is independent from the other both legally and economically – according to which the franchisor, in exchange for payment, grants the franchisee a set of industrial and intellectual property rights (eg, trademarks, commercial trade names, displays, utility models, designs, copyright, know-how, patents, and technical and commercial assistance or consulting). In executing a franchise agreement, the franchisee becomes part of the network of franchisees operating within a determined territory aimed at promoting specific goods or services.

In practice, one of the main purposes of franchising is the creation of a collaborative system and a productive distribution network.

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

Italy enacted a general law on franchising in 2004 and an implementing regulation thereto in 2005. The relevant laws are:

- the Franchising Act, which came into effect on 25 May 2004;
- Ministerial Decree 204/2005 (regulation on commercial franchising – the Franchising Regulation);
- Act 287/1990 (rules on the protection of competition and the market – the Antitrust Law);
- the EU Block Exemption Regulation on Vertical Restraints (330/2010), which is directly applicable in Italy (the previous EU Regulation 2790/1999 having expired); and
- Act 192/1998 (regulation of sub-supply within the production activities) – in particular, section 9 on the abuse of economic dependence (the Anti-Economic Abuse Law).

These laws and regulations provide no agency for the sale or offer of franchises and operate on a general level. No particular exemptions or exclusions are provided.

Principal requirements

14 | What are the principal requirements governing the offer and sale of franchises under the relevant laws?

The Franchising Act

The Franchising Act provides the most common mandatory rules applicable to franchise agreements, which generally protect prospective franchisees.

According to section 3 of the Franchising Act, a franchise agreement must be executed in written form to become legally valid. The franchisor must have experimented with its own business formula on the market. The minimum duration of the agreement must put the franchisee in the position to have a return on the investment and cannot be less than three years. Further, at least 30 days before the agreement's prospective execution date (cooling-off), the franchisor must provide the prospective franchisee with a copy of the agreement to be signed and any relevant information concerning the franchisor's activity, including:

- basic information relevant to the agreement, such as:
  - the amount of investment and entry fees to be paid by the franchisee before starting its activities;
  - the royalties and fees to be paid to the franchisor;
  - details of territorial exclusivity, if any;
  - the know-how to be transferred to the franchisee;
  - the criteria for the recognition of know-how added by the franchisee;
  - the services and assistance rendered by the franchisor; and
  - the renewal, termination and assignment rules of the agreement;
- the contractual relationships between franchisor and franchisee, including the transfer of trademarks and other intellectual property rights and the pre-contractual obligations that the parties must comply with (for example, reference is made to the disclosure of information and data useful for the stipulation of the contract (sections 4 to 6 of the Franchising Act));
- the possibility to agree, apart from the ordinary jurisdiction clauses or arbitration rules, on a conciliation (alternative dispute resolution) procedure before the chamber of commerce of the territory in which the franchisee is located; and
- circumstances under which the contract may be declared void (section 8 of the Franchising Act).

The Franchising Regulation

The Franchising Regulation applies exclusively to franchisors active outside Italy. It mainly sets out the rules on the pre-disclosure obligations of foreign franchisors towards franchisees.

The Franchising Regulation states that, at least 30 days before the prospective execution date of the agreement, the franchisor must deliver to the prospective franchisee a complete set of all contractual documents and the attachments thereto. Further, within the same 30-day period, the franchisor must deliver a list of franchisees operating in each single state and the number of sales points related thereto. At the request of the prospective franchisee, the franchisor must also deliver the contact details of at least 20 operating franchisees, as well as information on judicial proceedings.

The Antitrust Law

Should a commercial agreement be qualified as an agreement that gives rise to anticompetitive issues from an antitrust perspective (as with certain exclusivity clauses in franchising or distribution agreements), unless such an agreement falls under the EU Block Exemption Regulation on Vertical Restraints, it may be prohibited by the Antitrust Law.

The Anti-Economic Abuse Law

Section 9 of this legislation states that any agreement that is the result of one or more entity's abuse of the existing economic dependence of another undertaking is null and void.

Abuse exists if the dominant entity can take advantage of the other entity, so that the agreement may result in a gross disparity between the parties. The dependence is also evaluated in light of the possibility of the weak entity obtaining alternatives from the market.

The application of the Anti-Economic Abuse Law to franchising has been widely debated. Recent case law has denied that it applies to franchises due to the fact that franchise contracts are per se agreements between a strong and a weak entity, whereby the strong one imposes its business model on the weaker one. Franchise agreements should be upheld under the freedom of contract principle; therefore, the opinion that the Anti-Economic Abuse Law should not apply to a franchise system seems to be correct.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

Neither the Franchising Act (applicable to franchise contracts governed by Italian law for franchisors that already operate in Italy) nor the Franchising Regulation (applicable exclusively to franchisors that operate only outside Italy where the agreement is subject to Italian law) set any minimum period for having been in business before operating in Italy.

However, the Franchising Act requires franchisors, as part of their pre-contractual information duties, to provide franchisees with a list of affiliated franchisees and changes to affiliated franchisees in the past three years, or at least as of the date of the start of business. This pre-contractual obligation implies that there must be a minimum level of activity and franchisees for a franchisor to start a franchise business in Italy. The exact determination of the business must be examined on a case-by-case basis.

However, the Franchising Regulation sets a more stringent requirement for the pre-contractual information duties of franchisors that have operated exclusively outside Italy. They must provide the prospective franchisee with a list of franchisees divided by country of operation. On the request of the franchisee, the franchisor must provide a list of at least 20 affiliated franchisees or, if the number is below 20, the complete list of franchisees. Therefore, similar to the Franchising Act, the minimum business requirements for foreign franchisors must be evaluated on a case-by-case basis. So, although there is no minimum period to have been in business, the pre-contractual information duties require franchisors to provide information on an existing business to the prospective franchisor, the content of which must be evaluated on a case-by-case basis.

Further, section 3 of the Franchising Act provides that, to create a franchising system, the franchisor must have tested such a commercial system in a relevant market to protect potential franchisees from becoming involved with commercial systems that exist only 'on paper'. In the absence of any provision in the Franchising Act, the Italian Franchising Association Code of Ethics provides for a minimum duration of one year for such market testing.

Alternatively, franchisors may expressly indicate in their franchising agreements that a franchising formula has not yet been tested in the market. Should this be the case, the potential franchisee would be aware of any connected risks when deciding whether to enter into the franchising agreement. If the franchisor does not inform the potential franchisee about a lack of previous testing of its franchising system in the market, the franchisee is entitled to take action to annul the franchising agreement pursuant to sections 1.337 and 1.338 of the Italian Civil Code, and specifically for a violation of the pre-contractual good faith obligation.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

Neither the Franchising Act nor the Franchising Regulation restrict the manner in which a franchisor can recruit franchisees or select its own or its franchisees' suppliers.

Nevertheless, as to the location of the franchised outlets, even if territorial exclusivity is not required as a necessary part of the franchise agreement pursuant to section 3.4(c) of the Franchising Act, franchisees are part of a network of franchisees operating within a determined territory and must be strategically distributed. Thus:

- the franchisor must inform the franchisee of the outlets involved within the network (section 4.1(d) of the Franchising Act) and must inform the franchisee each year of changes concerning the other franchised outlets in the franchised network (section 4.1(e) of the Franchising Act); and
- the franchisee cannot move its franchised outlet if the franchise agreement specifically provides the respective location, except by reason of force majeure, and provided that the franchisor agrees (section 5.1 of the Franchising Act).

Apart from the provisions set out under the Franchising Act and the Franchising Regulation (in the case of a franchisor originally operating outside Italy), any other commercial provisions are left to the contracting parties, franchisor and franchisees.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

Under sections 4 and 6 of the Franchising Act, franchisors must disclose to franchisees a complete set of information, with the exception of that which is actually reserved or whose disclosure may violate third-party rights, at least 30 days before the stipulation of the contract (cooling-off).

Section 4 of the Franchising Act also states that franchisors must make this disclosure to the prospective franchisee within the cooling-off period. The disclosure obligation is therefore limited only to the pre-contractual phase, while the performance of the contract must be carried out by the parties in compliance with the principle of good faith set out in section 1375 of the Civil Code. In light of the above, the Franchising Act imposes no duty on franchisors to update the information disclosed in the pre-contractual phase.

Pre-contractual disclosure – content

18 | What information is the disclosure document required or advised to contain?

Pursuant to sections 4 and 6 of the Franchise Act, the franchisor must disclose to the franchisee a complete set of information, with the exception of that which is sensitive or whose disclosure may violate third-party rights, at least 30 days before the contract is signed.

Different information must be disclosed by the franchisor depending on whether the franchisor operates within or exclusively outside Italy. A franchisor operating exclusively within Italian territory or both in Italy and abroad must provide the franchisee with a copy of the contract to be signed and the following information:

1 data regarding the franchisor;
2 information concerning the trademarks used in the network;
3 a summary description of the activities and characteristics of the business concept of the franchise network;
4 a list of franchisees operating within the network and the physical locations of the franchisor;
5 an indication of the annual variation of the number of franchisees and their relevant location within the past three years, or from the beginning of the franchise activity if it started less than three years ago; and
6 a summary description of court or arbitration proceedings, or both, involving the franchise network at issue that have been started by franchisees, third parties or public authorities against the

franchisor and concluded in the past three years, in compliance with data protection provisions.

According to the Franchise Regulation, a franchisor that operates exclusively outside of Italy must provide the franchisee with the information described in (1), (2) and (3), along with the following:

- a list of franchisees operating within the network, and of the physical locations of the franchisor, sorted country by country (if requested by the franchisee, the franchisor must also supply the franchisee with a list of at least 20 franchisees operating within the network and their relevant locations);
- an indication of the annual variation – sorted country by country – of the number of franchisees and their relevant locations within the past three years or, if it started less than three years ago, from the beginning of the franchise activity; and
- a summary description of any court proceedings concluded with a final judgment within the three years preceding the contract being signed and arbitral proceedings concluded by a final award within the same time frame as described above.

Both the specified court and arbitration proceedings must concern the franchise system. In this regard, the franchisor must provide at least the following information:

- the parties involved;
- the judicial or arbitral authority;
- the claims; and
- the decision or award.

Pre-sale disclosure to sub-franchisees

19 | In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Section 2 of the Franchising Act also applies to sub-franchising. However, it provides no rules as to who must make pre-sale disclosures to the sub-franchisees. That said, given the fact that sub-franchisors are delegated to manage the entire franchise structure in a given territory, such pre-sale disclosure must in practice be made by the sub-franchisor. Given that the pre-sale disclosure rules regarding franchisors apply to sub-franchisors, they must therefore disclose at least what is provided for in section 4 of the Franchising Act.

Sub-franchisors must act with regard to their sub-franchisees according to the principles of good faith, fair dealing and loyalty (section 6 of the Franchising Act) in the pre-sale phase and onwards. With regard to their relationship with the franchisor, sub-franchisors must in principle disclose any further information requested by sub-franchisees that is reasonably relevant to the franchise business, unless such information can be regarded as confidential or its communication would violate third-party rights.

Due diligence

20 | What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

Before entering into a franchising agreement, franchisors should verify the reliability of the prospective franchisee, especially from a financial standpoint. The prospective franchisee will be requested to pay royalties and other amounts provided by the agreement (eg, an entry fee and advertising contribution). Franchisors should therefore evaluate before the relationship starts whether the prospective franchisee is a reliable subject to work with and whether they will be able to properly manage their activity in order to avoid damaging the franchisor's reputation.

In turn, prospective franchisees should evaluate the type of business that they will run under the franchising agreement. Further, as the prospective franchisee assumes the risk of a new activity, it should verify the solidity of the franchising system and trademark. The prospective franchisee should also verify the costs that it will have to pay (ie, royalties, minimum fees, entry fees, etc).

Both franchisor and franchisees should perform their respective verifications with the impact of covid-19 on the planned business activities of the franchising system taken into account.

Failure to disclose – enforcement and remedies

21 | What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

There is no statutory provision on this specific issue; however, sub-franchisors must disclose to sub-franchisees all of the information required under section 4 of the Franchising Act. That said, franchisors are held liable for any disclosure violation to sub-franchisors and sub-franchisees connected to the information required under section 4 of the Franchising Act. Conversely, if the disclosure violation occurs in the process of disclosure by the sub-franchisor and the sub-franchisees or does not consist of false information disclosed by the franchisor, or both, the latter would not be held liable for a disclosure violation. In this case, only the sub-franchisor would be liable.

In principle, individual officers, directors and employees of the franchisor or the sub-franchisor cannot be held personally liable, unless it can be proved that they acted under tort (fraud or negligence) or committed a crime punishable under the Criminal Code.

Failure to disclose – apportionment of liability

22 | In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

From a contractual point of view, violation of the disclosure obligations by the franchisor allows the franchisee to claim annulment of the agreement pursuant to section 1439 of the Italian Civil Code, together with compensation for damages, if due, pursuant to section 8 of the Franchising Act.

In the case of sub-franchisees, the master franchisee is responsible for the disclosure of non-compliance or for pre-contractual misrepresentation towards the sub-franchisees, which act in this sense as the franchisor. In any case, the franchisor's duty of control over the master franchisee cannot be excluded. In fact, whenever the franchisor violates his or her duty of control, there could be a non-contractual liability on the franchisor's part towards the franchisee.

General legal principles and codes of conduct

23 | In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

The Franchising Act provides for specific pre-contractual obligations for both franchisors and franchisees. Franchisors must exercise goodwill, fairness and good faith at all times when dealing with a prospective franchisee. Further, the franchisor must provide the prospective

franchisee with any information that the franchisee considers necessary or useful for the purposes of the franchise agreement in a timely manner. However, franchisors can withhold information that is reasonably deemed to be confidential or if such a disclosure could infringe third-party rights. At the same time, prospective franchisees must exercise goodwill, fairness and good faith at all times in dealing with the franchisor. Prospective franchisees must provide the franchisor with any information that is necessary or appropriate for the purposes of the franchise agreement, in a timely, correct and comprehensive way.

In light of the foregoing, good faith, fairness and also general principles of loyalty affect the offer and sale of franchises during pre-contractual, contractual and post-contractual phases pursuant to sections 1175, 1337, 1358 and 1375 of the Italian Civil Code.

In addition to the Franchising Act and the Franchising Regulation, private organisations that may have an influence on franchise activity include the Italian franchising association Assofranchising and the Italian franchising federation Federfranchising, which have issued specific codes of conduct with which their members must comply.

Fraudulent sale

24 | What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

From a contractual point of view, a franchisor's violation of the disclosure obligations allows the franchisee to claim annulment of the agreement under section 1439 of the Civil Code, together with compensation for damages, if due, pursuant to section 8 of the Franchising Act.

Conversely, a violation of said obligation has no criminal consequences and requires no involvement of government agencies.

The Franchising Act expressly provides for the annulment of the agreement should any party disclose false information to the other. In any event, such annulment must in principle be requested and declared by a judge or an arbitration panel.

Pursuant to section 1439 of the Italian Civil Code, expressly mentioned by section 8 of the Franchising Act, any agreement may be annulled if false information disclosed by one of the parties led the other to sign the contract.

As to damages, in principle, only the material loss suffered and proved should be recoverable. It is unclear whether loss of profit could be recoverable, as this provision of the Franchising Act has yet to be interpreted by the courts.

Sub-franchisors must disclose to sub-franchisees all of the information required under section 4 of the Franchising Act. That said, franchisors are held liable for any disclosure violation to sub-franchisors and sub-franchisees connected to the information required under section 4 of the Franchising Act. Conversely, if the disclosure violation occurs in the process of disclosure by the sub-franchisor and the sub-franchisees or does not consist of false information disclosed by the franchisor, or both, the franchisor would not be held liable for disclosure violation. In this case, only the sub-franchisor would be liable.

In principle, individual officers, directors and employees of the franchisor or the sub-franchisor cannot be held personally liable, unless it can be proved that they acted under tort (fraud or negligence) or committed a crime punishable under the Criminal Code.

Franchisors may terminate a franchise relationship in the case of default or non-performance of the franchisee's obligations. In general, termination is granted if the breach of the agreement can be considered a serious breach (eg, a default in payment of fees and royalties, a violation of any exclusivity rights on the product or non-compliance with the franchisors' standards). In any case, the agreement should clearly state the cases in which the franchisor can terminate the franchise relationship without a notice period.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 | What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The Franchising Act

Act 129/2004 (the Franchising Act) provides the most common mandatory rules applicable to franchise agreements, which generally protect prospective franchisees.

According to section 3 of the Franchising Act, a franchise agreement must be executed in written form to become legally valid. The franchisor must have experimented with its own business formula on the market. The minimum duration of the agreement must put the franchisee in the position to have a return on the investment and cannot be less than three years. Further, at least 30 days before the agreement's prospective execution date (cooling-off), the franchisor must provide the prospective franchisee with a copy of the agreement to be signed and any relevant information concerning the franchisor's activity, including:

- basic information relevant to the agreement, such as:
  - the amount of investment and entry fees to be paid by the franchisee before starting its activities;
  - the royalties and fees to be paid to the franchisor;
  - details of territorial exclusivity, if any;
  - the know-how to be transferred to the franchisee;
  - the criteria for the recognition of know-how added by the franchisee;
  - the services and assistance rendered by the franchisor; and
  - the renewal, termination and assignment rules of the agreement;
- the contractual relationships between franchisor and franchisee, including the transfer of trademarks and other intellectual property rights and the pre-contractual obligations that the parties must comply with (for example, reference is made to the disclosure of information and data useful for the stipulation of the contract (sections 4 to 6 of the Franchising Act));
- the possibility to agree, apart from the ordinary jurisdiction clauses or arbitration rules, on a conciliation (alternative dispute resolution) procedure before the chamber of commerce of the territory in which the franchisee is located; and
- circumstances under which the contract may be declared void (section 8 of the Franchising Act).

The Franchising Regulation

Ministerial Decree 204/2005 (regulation on commercial franchising – the Franchising Regulation) applies exclusively to franchisors active outside Italy. It mainly sets out the rules on the pre-disclosure obligations of foreign franchisors towards franchisees.

The Franchising Regulation states that, at least 30 days before the prospective execution date of the agreement, the franchisor must deliver to the prospective franchisee a complete set of all contractual documents and the attachments thereto. Further, within the same 30-day period, the franchisor must deliver a list of franchisees operating in each single state and the number of sales points related thereto. At the request of the prospective franchisee, the franchisor must also deliver the contact details of at least 20 operating franchisees, as well as information on judicial proceedings.

The Antitrust Law

Should a commercial agreement be qualified as an agreement that gives rise to anticompetitive issues from an antitrust perspective (as

with certain exclusivity clauses in franchising or distribution agreements), unless such an agreement falls under the EU Block Exemption Regulation on Vertical Restraints (330/2010), it may be prohibited by Act 287/1990 (rules on the protection of competition and the market – the Antitrust Law).

The Anti-Economic Abuse Law

Section 9 of Act 192/1998 (regulation of sub-supply within the production activities the Anti-Economic Abuse Law) states that any agreement that is the result of one or more entity's abuse of the existing economic dependence of another undertaking is null and void.

Abuse exists if the dominant entity can take advantage of the other entity, so that the agreement may result in a gross disparity between the parties. The dependence is also evaluated in light of the possibility of the weak entity obtaining alternatives from the market.

The application of the Anti-Economic Abuse Law to franchising has been widely debated. Recent case law has denied that it applies to franchises due to the fact that franchise contracts are per se agreements between a strong and a weak entity, whereby the strong one imposes its business model on the weaker one. Franchise agreements should be upheld under the freedom of contract principle; therefore, the opinion that the Anti-Economic Abuse Law should not apply to a franchise system seems to be correct.

Apart from the specific laws indicated above, the general provisions set out in the Italian Civil Code govern the contractual relationship.

Operational compliance

26 | What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

In general, franchisors provide franchisees with operational manuals and detailed instructions so that the franchisees have all the tools to comply with the franchising system.

In order to ensure franchisee compliance with the operational terms and standards of the agreement during the relationship, franchisors may include a specific provision granting them the right to carry out inspections at the franchisee's premises to ascertain franchisee compliance.

Franchisors should ensure, through specific contractual clauses to be implemented in the franchise agreement, that franchisees comply with mandatory applicable guidelines for the performance of the specific activity to be carried out, in particular with respect to health and safety issues (connected, for example, to the covid-19 pandemic) and include in the manuals all the relevant procedures and information.

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

Franchisors generally cannot unilaterally change operational terms and standards during an agreement, especially if the changes are material and likely to alter the object of the contractual relationship between the parties. That said, many franchising agreements include clauses providing the right for the franchisor to change unilaterally, for example, the products to be sold by the franchisee. However, such clauses do not allow franchisors to make unlimited changes.

Policy affecting franchise relations

28 | Do other government or trade association policies affect the franchise relationship?

Neither the government nor any trade association may in principle affect the franchise relationship. However, the Italian Association of Franchising and the Italian Federation of Franchising have issued specific codes of conduct with which all of their members must comply. In principle, such codes may extend the obligations set out by law to further protect the weaker party in the franchise relationship.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Franchisors may terminate a franchise relationship in the case of default or non-performance of the franchisee's obligations. In general, termination is granted if the breach of the agreement can be considered a serious breach (eg, a default in payment of fees and royalties, a violation of any exclusivity rights on the product or non-compliance with the franchisors' standards). In any case, the agreement should clearly state the cases in which the franchisor can terminate the franchise relationship without a notice period.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

Franchisees may terminate the relationship based on a serious breach of the contract terms by the franchisor.

If a franchisee terminates the agreement, it is entitled to reimbursement of the initial fees and costs, damages, or both. In practice, because of the extreme difficulties in proving and quantifying damages, franchise agreements usually grant the franchisee the right to be reimbursed the entrance fee, if any, or an obligation for the franchisor to repurchase the franchisee's stock. However, a typical franchise agreement may include a penalty fee in favour of the franchisor if the franchisee terminates the agreement without reasonable cause.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

The parties are free to determine the renewal conditions. If they decide to renew the agreement, they are free to change the conditions therein.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Under section 3.4(g) of the Franchising Act, renewal conditions must be set out in the agreement, therefore it is crucial to state such conditions clearly. However, in principle, there is no legal obligation for a franchisor to renew the franchise agreement.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Pursuant to section 3.4(g) of the Franchising Act, the terms for transfer of the contract must be expressly indicated therein. Restrictions are therefore permitted.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

There are no legislative measures on or restricting the nature and amount of fees.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

The amount of interest on overdue payments can be specified in the contract. However, it cannot exceed the usury rate that is fixed every three months by a ministerial decree. In general, the maximum rate is between 10 and 20 per cent each year, depending on the nature of the relevant business. In the absence of specific contractual provisions, the tax rate is determined by a specific law on overdue payments in commercial transactions and the Italian Civil Code.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There are no currency restrictions regarding payments by national (local) franchisees of royalties and other payments to non-resident franchisors in their domestic currency. However, certain anti-money laundering requirements may impose specific restrictions. In principle, payments can be made only through an authorised bank or a financial intermediary (eg, bank wire or cheques).

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Yes, according to the general principles of Italian law on general covenants. Franchise agreements should provide for specific penalties that the party that breaches the covenant must pay to make it easier to quantify the damage suffered by the compliant party.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Section 6 of the Franchising Act sets out the franchisor's express duty to act under the principles of good faith, fair dealing and loyalty with regard to prospective franchisees during the pre-sale phase.

Under sections 1337 and 1375 of the Civil Code, all parties must deal in good faith during both the pre-sale and the post-sale phase (after the formation of the contract). This principle was reaffirmed by a recent Supreme Court decision stating that a franchise agreement requires a tight and loyal collaboration between the franchisor and the franchisees. Failure to comply with such obligations can be taken into consideration by the courts when evaluating the liability of the parties or calculating the damages, and with respect to termination issues.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

No. A franchisee within a franchise structure is always qualified as a business entity. Therefore, it has a fiscal code, and must generally request a value added tax code and be registered with the competent local register of undertakings.

However, within an atypical franchise structure, the franchisees may be qualified as professionals or semi-professionals, which in principle should exclude them from being treated as consumers (although this is not always the case), or as occasional professionals without any organisation or entrepreneurial risk (eg, in a franchise system that contemplates the door-to-door sale of the franchise's products, where the franchisee does not have to purchase the goods from the franchisor or any of its qualified suppliers within the franchise system).

In such an atypical franchise system, the franchisee may well be treated as a consumer, with all associated consequences, especially regarding the right to withdrawal and other protection rights.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

In principle, the Italian language is not mandatory for franchise agreements. However, should a franchisee request an Italian version of the franchise agreement, the franchisor must comply with this request under section 3(1) of the Franchising Regulation. If parties agree on a foreign language, it is advisable that the domestic party declares in the contract that he or she has sufficient knowledge of the foreign language to understand the content of the agreement.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

Under section 3(3) of the Franchising Act, the first term of the franchise cannot be less than three years (except when terminated for breach of contract).

As to restrictions on purchases or leases of goods or services, they may be considered harsh conditions that, according to section 1341(2) of the Italian Civil Code, must be expressly approved by a second signature.

Parties can choose the law governing the contract and enter into any agreements on arbitration or alternative dispute resolution rules.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Italy has different courts depending on the relevant case matter (ordinary, administrative and tax courts). A typical franchise agreement falls under the ordinary jurisdiction, which is a three-level system: the first-instance court, the Court of Appeal and the Supreme Court. In general, Italian court proceedings can last a long time (up to two or three years for a first-instance judgment). It is therefore advisable to opt for arbitration.

The Code of Civil Procedure contains specific arbitration rules. Parties may choose between a ritual arbitration, an arbitration under the rules of a chamber of commerce (typically Milan) or any other relevant domestic or international organisation (eg, the Rome branch of the International Chamber of Commerce).

Notably, the Italian Federation of Franchising provides for alternative dispute resolution solutions specifically tailored to franchises.

Governing law

43 Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

Parties have, in general, the possibility to select a foreign governing law but mandatory provisions of the Franchise Act always apply (for example, concerning the contract's minimum duration and the pre-contractual disclosure obligations). If a foreign governing law has been chosen, contractual obligations between the parties – with respect to breach of contract, etc – will be decided based on the chosen foreign law that, if brought in front of an Italian court, could lead to a more complicated judicial process. Therefore, if a foreign governing law has been chosen, it is advisable to designate a court of the nominated country that will make a judgment based on its own domestic laws in case of any controversy.

Arbitration – advantages for franchisors

44 What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

The advantages of a foreign franchisor choosing arbitration over ordinary court proceedings are:

- speed (even though the arbitration decision may be appealed, which would mean the commencement of ordinary proceedings of the usual duration);
- the possibility of choosing the arbitrators;
- the highest level of efficiency during the procedure, as the arbitration procedure does not fall within the court procedure and is therefore not affected by common delays experienced in court; and
- confidentiality (possibly the most important advantage).

The fact that the arbitration procedure and decisions are private may represent a significant advantage for parties that wish to keep the results of litigation undisclosed. Further, franchisors may choose the applicable rules governing the procedure, language of the arbitration and seat. Conversely, should the parties to a contract decide on arbitration, the major disadvantages are the high costs of the procedure and the difficulty of finding experienced arbitrators. This is also a problem from another perspective: the parties to an arbitration are more inclined to choose an arbitrator for their impartiality rather than their skills as a judge.

National treatment

45 In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

In principle, the only relevant differences are set out in the Franchising Regulation regarding pre-contractual duties where the franchisor operates outside Italy, provided that the agreement is subject to Italian law. From a practical point of view, foreign franchisors that are internationally unknown, have been in business for a short period and cannot show a consolidated international business model may be treated differently to national franchisors in court.

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UPDATE AND TRENDS

Legal and other current developments

46 Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

No new legislation or legislative amendments specific to franchising have been announced. In recent years, an electronic invoice system has been introduced in Italy, which applies to all domestic entities.

The covid-19 pandemic has had a considerable impact on all business activities, including franchising, but it has to be pointed out that the franchising system – which is based on a partnership between franchisors and franchisees within a common system – has proven to be particularly resilient. In the first few months of 2021, several Italian franchisors, including in the food sector, announced the opening of new points of sale and an increase in the size of their network, both in Italy and abroad. From a strictly legal point of view, it is advisable to include specific covid-19 clauses in future franchise agreements that ensure compliance with any governmental provisions and restrictions. These clauses should also enable both franchisor and franchisee to implement all activities necessary to safeguard the franchising system and the relevant businesses, based on a fair balance between the parties.

* *The information contained in this chapter is accurate as at 3 June 2021.*

Japan

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MARKET OVERVIEW

Franchising in the market

1 | How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Franchising is very widespread in Japan. According to the data published by the Japan Franchise Association, for the period from April 2020 to March 2021, the number of chains operating in Japan stood at 1,308, with 254,017 stores and a total turnover of ¥25.42 trillion. Among other sectors, convenience stores are particularly common in Japan, with a total of 57,999 outlets as at 2020.

Associations

2 | Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The Japan Franchise Association (JFA) was established in 1972 for the purposes of planning and promoting the healthy development of the franchise system. It has implemented voluntary rules, such as the JFA's Code of Ethics and the Voluntary Standard Regarding Disclosure and Explanation of Information to Prospective Franchisees. In addition to maintaining these voluntary rules, it also conducts research and educational training, and provides consultations.

BUSINESS OVERVIEW

Types of vehicle

3 | What forms of business entities are relevant to the typical franchisor?

Most typical franchisors are organised in the form of a joint-stock company.

Regulation of business formation

4 | What laws and agencies govern the formation of business entities?

The formation of joint-stock companies in Japan is governed by the Companies Act (Act No. 86, 2005), under the supervision of the Ministry of Justice.

Requirements for forming a business

5 | Provide an overview of the requirements for forming and maintaining a business entity.

The formation of a joint-stock company requires articles of incorporation and other incorporation documents to be prepared and registered at a competent legal affairs bureau. After incorporation, it is necessary to prepare financial statements and to hold a shareholders' meeting each year.

Restrictions on foreign investors

6 | What restrictions apply to foreign business entities and foreign investment?

Foreign business entities must register their representatives in Japan in order to conduct business continuously in the country. Once registered, they can carry out business in the same way as domestic entities. In addition, foreign investment is regulated by the Foreign Exchange and Foreign Trade Act (Act No. 228 of 1949). Industry-specific laws may also apply, depending on the business sector of the foreign entities.

Taxation

7 | What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

Franchisors in the form of joint-stock companies need to pay corporate tax, corporate enterprise tax, corporate inhabitant tax and consumption tax. Depending on the nature of the assets held by a franchisor, property tax and automobile tax may also be payable. Foreign businesses' and individuals' income sourced in Japan is generally subject to Japanese taxation.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

Labour regulations generally apply to franchisors with regard to the relationship between franchisors and their respective employees. In a typical franchise arrangement, a franchisee or the employees of a franchisee are not considered to be employees of the franchisor. To avoid the risk that a franchisee could be deemed employees of the franchisor, a franchisor must structure the franchise relationship so that the franchisee is an independent entity and must clearly explain the independent nature of the franchise relationship with the franchisee. In addition, to avoid the risk that employees of a franchisee could be deemed employees of a franchisor, it is advisable that a franchisor is not involved in the hiring process of employees of a franchisee and that it is clearly explained to the candidates that the employer will be the franchisee, not the franchisor. Breach of labour regulations may result in criminal penalties including imprisonment.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

Franchisors can register trademarks to protect such marks from infringing use. Nevertheless, there is no registration system per se for know-how. Know-how that falls within the scope of registrable types of intellectual property – such as patents or designs – may be registered accordingly. In addition, if the know-how falls within the definition of a 'trade secret' under the Unfair Competition Prevention Act (Act No. 47 of 1993), it will be protected against any acts constituting unfair competition.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

In general, a franchisee leases real estate for its operations directly from a property owner. Disputes may arise when the lessor tries to increase the rent or terminate or refuse to renew the lease agreement. In such situations, protection is available to the franchisee under the Land Lease and Building Lease Act (Act No. 90, 1991) and the doctrine of the destruction of a relationship of mutual trust, which limits a lessor's ability to terminate a lease agreement to the case that the mutual trust relationship is destroyed because of the lessee's violation of the agreement (Supreme Court, 28 July 1964, *Minshu* 18-6, p1220; 21 April 1966, *Minshu* 20-4, p720).

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

The Act on Prohibition of Private Monopolisation and Maintenance of Fair Trade (Act No. 54 of 1947) (the Antimonopoly Act) and its relevant regulations and gudelines such as Guidelines Concerning the Franchise System (the Franchise Guidelines) and Distribution Guidelines. The guidelines describe what kind of activities or restrictions are problematic under the Antimonopoly Act. In particular, the franchisor must ensure that none of its activities fall under a category of unfair trade practices specified in the Antimonopoly Act or described by the JFTC in its Designation of Unfair Trade Practices.

First, the Franchise Guidelines require franchisors to disclose sufficient and accurate information when they are soliciting prospective franchisees or their actions can be deemed to be deceptive customer inducement, which is one of categories of conducts restricted as unfair trade practice (Designation of UTP, item 8).

Second, the Franchise Guidelines regulate transactions between franchisors and franchisees. The Franchise Guidelines state that it could be an abuse of a superior bargaining position to limit parties with whom franchisees can make transactions, to compel franchisees to buy a designated amount of goods, to restrict the ability of the franchisees to offer discounts to their customers or to restrict competitive activities after the termination of a franchise agreement. It also states what kind of items should be considered in connection with tie-in sales (Designation of UTP, item 10), dealing on restrictive terms (Designation of UTP, item 12) and resale price restriction.

If a party's activity is considered to be unfair trade practices under the Antimonopoly Act, the Fair Trade Commission may impose administrative sanctions, such as a cease and desist order which orders the breaching party to stop the illegal activities, to delete the clauses concerned from the agreement, and to take any other measures necessary to eliminate such activities. Some of the categories, such as abuse of a superior bargaining position and resale price restrictions, could be subject to surcharges under the Antimonopoly Act.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

There is no uniform definition of a franchise in Japan. Nevertheless, there are three relevant definitions with regard to franchise businesses.

First, the Medium and Small Retail Commerce Promotion Act (Law No. 110 of 1973) (MSRCPA) defines a 'chain business' as a business that, pursuant to an agreement with uniform terms and conditions, continuously sells or acts as an agent for sales of products and provides guidance regarding management, and primarily targets medium and small retailers. In addition, a 'specified chain business' is defined as:

> *any chain business the agreement for which includes clauses that permit its members to use certain trademarks, trade names or any other signs, and collects joining fees, deposits or any other money from the member when becoming a member[.]*

If a franchise business falls under this definition, the disclosure obligation etc. under the MSRCPA apply.

Second, the Guidelines Concerning the Franchise System (the Franchise Guidelines) under the Act on Prohibition of Private Monopolisation and Maintenance of Fair Trade (Act No. 54 of 1947) (the Antimonopoly Act) provides the following:

> *The franchise system is defined in many ways. However, the franchise system is generally considered to be a form of business in which the head office provides the member with the right to use a specific trademark and trade name, and provides coordinated control, guidance, and supports for the member's business and its management. The head office may provide support in relation to the selling of commodities and the provision of services. In return, the member pays the head office.*

Third, the Japan Franchise Association (JFA) defines a franchise as:

> *A continuing relationship between one business operator (called a Franchisor) and another business operator (called a Franchisee) where a Franchisor and a Franchisee enter into a contractual agreement, the Franchisor granting the Franchisee the right to conduct the product sales and other businesses under the same image, by using the Franchisor's trademark, service mark, trade name or other signs representing the Franchisor's business, as well as the Franchisor's management know-how; the Franchisee paying the consideration to the Franchisor in return, investing the fund necessary for the business, and operating the business under the Franchisor's guidance and assistance.*

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

If the franchise business falls within the scope of a specified chain business, the disclosure obligations under the MSRCPA is applicable in relation to the offer and sale of franchises. The Ministry of Economy, Trade and Industry, as well as other ministries depending on the the franchise business, have overall responsibility in this regard.

From the perspective of competition law, the Franchise Guidelines regulate the offer and sale of franchises from the viewpoint of the Antimonopoly Act, and the Fair Trade Commission has overall responsibility in this regard.

The JFA has also implemented voluntary rules, such as the Japan Franchise Association Code of Ethics and the Voluntary Standard Regarding Disclosure and Explanation of Information to Prospective Franchisees.

Principal requirements

14 What are the principal requirements governing the offer and sale of franchises under the relevant laws?

Under the MSRCPA, franchisors whose businesses fall under the definition of a specified chain business are required to provide a written document that describes prescribed items and to explain the contents of the written documents prior to executing a franchise agreement with prospective franchisees.

The Franchise Guidelines require franchisors to disclose sufficient and accurate information to prospective franchisees and also regulates the ongoing relationship between franchisors and franchisees.

Franchisor eligibility

15 Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

There is no such requirement in general, except for the disclosure requirements provided in the MSRCPA and the Franchise Guidelines. If the industry in which the franchise operates is regulated by industry-specific laws, it is necessary to check those regulations.

Franchisee and supplier selection

16 Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

In addition to the MSRCPA, which stipulates the disclosure requirements, the Franchise Guidelines regulate the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers. It is recommended that a franchisor, when recruiting a franchisee, discloses sufficient information to the franchisee to avoid any misunderstandings about the business on the part of the franchisor. This disclosure includes but is not limited to matters relating to the terms and conditions of supply of products, such as a system for recommending suppliers, and matters relating to any restrictions applying to the franchisor or other franchisees in setting up a similar or identical outlets close to the outlet planned by the franchisee. The Franchise Guidelines also mention that if the franchisor forces the franchisee to trade only with the franchisor or companies appointed by the franchisor regarding the supply of items such as products and raw materials without proper justification, it could be considered as an abuse of a superior bargaining position.

Pre-contractual disclosure – procedures and formalities

17 What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

Under the MSRCPA, when a franchisor intends to negotiate a franchise agreement with a prospective franchisee, the franchisor must provide written documents describing the prescribed items and explain the contents of the written documents to prospective franchisees. There are no regulations regarding the frequency of updating disclosures.

Pre-contractual disclosure – content

18 What information is the disclosure document required or advised to contain?

A franchisor whose business falls within the definition of a specified chain business under the MSRCPA is subject to the MSRCPA disclosure obligations.

Information about the following matters, which must include at least the items specified for each matter, must be disclosed to the franchisee:

- matters regarding the initial fee, deposit or any other money that the franchisor will collect at the time when the prospective franchisee becomes a franchisee:
  - the amount of money to be paid or the method of calculating the amount;
  - the nature of the money to be collected, such as whether it is an initial fee, deposit, equipment fee, etc.;
  - the timing of payment;
  - the method of collection; and
  - whether the money will be refunded, and the conditions applicable to such refund;
- matters regarding terms and conditions of sales of products sold to franchisees:
  - the type of products that are sold or arranged to be sold to the franchisees; and
  - the method of payment for such products;
- matters regarding management instruction:
  - whether there will be training or a seminar when joining;
  - the content of a training or a seminar, if provided; and
  - the method of continuous management instruction to franchisees and how many times such instruction will be conducted;
- matters regarding the trademark, trade name and any other indication that will be permitted to be used:
  - trademark, tradename and other indication that will be permitted to be used; and
  - if there are any terms and conditions regarding the use of the indication, the content thereof;
- matters regarding the duration of the agreement and renewal and termination of the agreement:
  - the duration of the agreement;
  - the conditions and procedure to renew the agreement;
  - the requirements and procedures to terminate the agreement; and
  - the amount of compensatory damages that will accrue on termination of the agreement or the methods to calculate the amount or the content of any other obligation;
- matters regarding changes in the number of franchisees' stores during the most recent three business years:
  - the number of franchisees' stores as at the last day of each business year;
  - the number of franchisees' stores that began operations during each business year;
  - the number of franchisees' stores whose franchise agreements have been terminated during each business year; and
  - the number of franchisees' stores whose franchise agreements were renewed during each business year and the number of franchisees' stores whose franchise agreements were not renewed during each year;

- matters regarding income and expenditure of franchisees with similar local conditions – such as the population of the surrounding area and the volume of traffic, among others – during the most recent three business years:
  - the following amount of the franchisee recognised by the franchisor;
    - the sales amount;
    - the sales cost;
    - the amount of money to be paid periodically by franchisees, such as royalties for the use of the business name, consulting fees, etc.;
    - the employment costs;
    - any service and general administration expenses; and
    - any other factors and figures that form the basis of the calculation of income and expenditure;
  - reasons why the location conditions of the franchisees are considered similar;
- matters regarding any periodic payments:
  - the amount of money to be paid periodically or the method of calculating the amount of money to be paid periodically;
  - the nature of the payment, such as whether it is a royalty for the use of the business name, a consulting fee, etc.;
  - the timing of payment; and
  - the method of collection of the payment;
- other matters:
  - the name and address of the franchisor, number of full-time employees and, if the franchisor is a company, the title and names of officers;
  - the amount of capital, names of the principal shareholders (those holding more than 10 per cent of the shares directly or indirectly) and, if the franchisor is conducting another business, the type of business;
  - the name of any entity in which the franchisor holds a majority of the voting shares;
  - the balance sheet and profit and loss statement, or other documents equivalent to these for the past three business years of the franchisor's business;
  - the date on which the franchisor began its specified chain business;
  - the number of litigation cases in which the franchisor is the plaintiff and a franchisee or ex-franchisee is the defendant with regard to the franchise agreement and vice versa during the past five business years;
  - business hours, business days and regular or irregular closing days of franchisees' units;
  - whether there is a provision stipulating whether the franchisor will engage in or allow other franchisees to engage in business operations conducting the same or similar retail business near the shops of the franchisee and the contents of the provision, if applicable;
  - whether there is a provision that prohibits or restricts the ability of franchisees to conduct businesses, such as prohibiting them from joining other specified chain businesses or from being employed with similar businesses (either during or after termination or expiration of the agreement) and the contents of the provision, if applicable;
  - whether there is a provision that prohibits or restricts disclosure of information that the franchisee may know regarding the specified chain business during or after termination or expiration of the agreement and the contents of the provision, if applicable;
  - whether the franchisees need to remit all or part of the sale proceeds periodically, and the timing and method thereof;
  - whether the franchisor lends or arranges to lend money to franchisees, the interest rate or the method of calculating the rate and any other conditions of the lending or arranging of lending;
  - whether the franchisor adds interest to all or part of the remaining amount after setting off the rights and obligations which accrue in connection with a transaction with the franchisor during a certain period, the interest rate or the method of calculating the rate and any other conditions;
  - whether the franchisor imposes on franchisees a special obligation regarding the structure, or interior or exterior of stores of franchisees, the contents of the obligation; and
  - the amount of money or the method of calculating the amount of money that accrues when the franchisor or a franchisee violates the agreement.

Pre-sale disclosure to sub-franchisees

19 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

In the case of a sub-franchise, the relationship between the sub-franchisor and the sub-franchisee needs to be analysed; if it falls within the definition of a specified chain business under the MSRCPA, the sub-franchisor owes a disclosure obligation. In such a case, the information relating to the sub-franchisor must be disclosed. The relationship between the franchisor and the sub-franchisor must also be analysed; if it too falls within the definition of a specified chain business, the franchisor has a disclosure obligation as well.

Due diligence

20 What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

It depends on the particular policy of the franchisor or the franchisee, but a general background check to ensure, among other things, that the counterparty is not an antisocial force and not associated with antisocial forces, is usually conducted.

Failure to disclose – enforcement and remedies

21 What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

A franchisor or a sub-franchisor whose business falls within the definition of a specified chain business under the MSRCPA owes disclosure obligations and any party who owes such obligations is responsible for any breach thereof. Generally, individual officers, directors and employees of the franchisor or the sub-franchisor are not exposed to a personal liability with regard to the failure of disclosure by the franchisor or the sub-franchisor. Nevertheless, if there are breaches of the duty of care or fault on the part of these individuals, they may face liability accordingly. In addition, there is a risk that a franchisee will name these individuals as defendants in a suit against the franchisor or the sub-franchisor to seek recovery of damages from them.

A franchisor or a sub-franchisor who failed to disclose sufficient and accurate information as required by the Franchise Guidelines could be deemed to have conducted a deceptive customer inducement, in which case, the JFTC may investigate and impose administrative sanctions.

Failure to disclose – apportionment of liability

22 | In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

A franchisor or a sub-franchisor whose business falls within the definition of a specified chain business under the MSRCPA owes disclosure obligations and any party who owes such obligations is responsible for any breach thereof. Generally, individual officers, directors and employees of the franchisor or the sub-franchisor are not exposed to a personal liability with regard to the failure of disclosure by the franchisor or the sub-franchisor. Nevertheless, if there are breaches of the duty of care or fault on the part of these individuals, they may face liability accordingly. In addition, there is a risk that a franchisee will name these individuals as defendants in a suit against the franchisor or the sub-franchisor to seek recovery of damages from them.

General legal principles and codes of conduct

23 | In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

Apart from the MSRCPA, the Franchise Guidelines and the JFA's voluntary rules, the general principles of the Civil Code (Act No. 89, 1896) affect the offer and sale of franchises. For example, franchisees can rescind the franchise agreement in the event of fraudulent disclosure of information or if there is a material misunderstanding about the franchise agreement. If damage has been caused by the violation of the disclosure requirement, franchisees may bring a claim for damages based on contract theory or tort theory.

Fraudulent sale

24 | What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

No special remedy exists for franchisees under the MSRCPA regarding violations of disclosure requirements. Therefore, in case of fraudulent or deceptive practices of franchisors, franchisees need to base any claims to cancel or rescind on the general principles of contract under the Civil Code. For example, franchisees can rescind the franchise agreement in the event of fraudulent disclosure of information or if there is a material misunderstanding about the franchise agreement. If damage has been caused by the violation of the disclosure requirement, franchisees may bring a claim for damages based on contract theory or tort theory. In addition, franchisees may claim that a franchisor is violating the Franchise Guidelines, thus violating the Antimonopoly Act.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 | What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The Guidelines Concerning the Franchise System (the Franchise Guidelines) under the Act on Prohibition of Private Monopolisation and Maintenance of Fair Trade (Act No. 54 of 1947) (the Antimonopoly Act) regulate the ongoing relationship between franchisors and franchisees, such as the matters relating to restriction on suppliers, forced purchase quota, restriction on bargain sales and amendments to the franchise agreement.

Operational compliance

26 | What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

Generally, franchise agreements obliges franchisees to comply with the Franchisor's operation manuals and othere rules that sets forth its brand standards in detail. In addition, various reporting requirements, which must be satisfied on a regular basis, are provided for in the franchise agreement. Franchisors also have inspection rights (also provided for in the franchise agreement) in order to check the records, etc, of franchisees whenever franchisors deem such inspections necessary.

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

It depends on to what extent the franchise agreement and other ancillary agreements give the franchisor the discretion to change operational terms and standards unilaterally. In general, the franchisor reserves the right to change the operational manual unilaterally. Even if such reight is reserved, the franchisors must be carefully check if such unilateral change imposes unreasonable burden on franchisees without any justifiable reason.

Policy affecting franchise relations

28 | Do other government or trade association policies affect the franchise relationship?

There are voluntary rules, such as the Code of Ethics and the Voluntary Standard Regarding Disclosure and Explanation of Information to Prospective Franchisees, prepared by the Japan Franchise Association (JFA). If a franchisor is a member of the JFA, its voluntary rules are an important consideration in the franchise relationship.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Usually, the franchise agreement lists the circumstances in which the franchisor may terminate a franchise relationship. In addition, if the franchisor and the franchisee mutually agree, the franchisor may also terminate a franchise relationship.

If there is no clause in the franchise agreement regarding the termination, pursuant to the Civil Code (Act No. 89, 1896), the franchisor may terminate the franchise agreement prior to the expiration of the term of the agreement if the franchisee violates the franchise agreement. Nevertheless, because franchise agreements are usually continuous long-term agreements, there is a possibility that courts will be more reluctant to terminate these agreements compared to normal agreements.

On this point, it may be useful to refer to the doctrine of the destruction of a mutual trust relationship, which has been established in the area of lease agreements that are also generally considered as continuous agreements. With regard to lease agreements, a lessor's ability to terminate a lease agreement is limited to the case that the mutual trust relationship is destroyed because of the lessee's violation of the

agreement (Supreme Court, 28 July 1964, *Minshu* 18-6, p1220; 21 April 1966, *Minshu* 20-4, p720). This means that a lessor may not terminate a lease agreement even if the lessee is violating it, provided that the violation is not sufficiently material to destroy the mutual trust relationship.

In the case of termination of a franchise agreement, similar consideration could be made by the court to restrict a franchisor's ability to terminate a franchise relationship, depending on the circumstances.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

Usually, the franchise agreement regulates the circumstances in which a franchisee may terminate a franchise relationship. In addition, the franchisee may terminate a franchise relationship due to mutual agreement with the franchisor. In cases where there is no clause in the franchise agreement, the same considerations apply as those relating to termination by the franchisor. However, in general, the necessity of protecting a franchisor from termination by a franchisee is not strong, as compared to the necessity of protecting a franchisee from termination by a franchisor, and, therefore, it would be generally easier for franchisees than a franchisor to terminate the franchise agreement.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

If the franchise agreement provides for an automatic renewal clause, there is no need to enter into a new agreement. If the franchise agreement requires the parties to renew the term, it is then necessary to enter into either a new agreement or an extension agreement.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Provisions in the franchise agreement generally determine whether a franchisor may refuse to renew the franchise agreement with the franchisee. In cases where the franchise agreement states that it will not be renewed unless otherwise agreed to between the parties, the franchisor may generally refuse to enter into a new agreement. On the other hand, in cases where the franchise agreement states that it will be renewed automatically unless either party notifies otherwise, it is unclear in which circumstances the franchisor may refuse to renew, especially after being renewed for many times. On this point, there is a case in which a court required 'compelling circumstances which make it difficult to continue the agreement for a franchisor to be able to refuse to renew a continuous agreement' (*Hokka Hokka Tei* case, Nagoya District Court, 31 August 1998).

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

As to the transfer of a franchise, it is possible to include a provision in a franchise agreement that requires the franchisor's consent for the franchisee to transfer its franchise under the agreement. Further, under the Civil Code, when a party to an agreement is going to transfer its status or obligations under the agreement, the other party's consent must be obtained. Therefore, even if there is no clause in the franchise agreement requiring consent for transfer, the franchisor's consent is still necessary.

As to the transfer of an ownership interest in a franchisee entity, the owner of an ownership interest in a franchisee entity is generally free to transfer its ownership interest. Any covenant in a franchise agreement that prohibits the owner to transfer an ownership interest in a franchisee is not enforceable against the owner unless the owner is also a party to the franchise agreement. However, the franchise agreement may indirectly restrict the transfer of an ownership interest in a franchisee entity by making it an obligation of the franchisee to obtain the franchisor's consent or by making the transfer of an ownership interest a termination event.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

There is no specific limitation on the amount or payment of fees. However, if fees are unreasonably high, the obligation to pay the fees may be deemed void because it may be construed to be against good public order and customs as laid out in the Civil Code. It is also possible that, depending on circumstances, imposition of high fee is considered as an abuse of superior bargaining position as laid out in the Antimonopoly Act.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

For interest on loans from a franchisor to a franchisee, the restriction on interest under the Interest Rate Limitation Act (Act No. 100 of 1954) applies; however, if the overdue payment is not in connection with a loan, there is no specific restriction on the amount of interest. If the interest charged is unreasonably high, however, the obligation to pay the interest may be deemed void because it is against good public order and customs as laid out in the Civil Code.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

In general, there are no restrictions on a franchisee's ability to make payments in a foreing currency. International transfer of funds exceeding certain amount is subject to a reporting requirement under the Foreign Exchange and Foreign Trade Act (Act No. 228 of 1949), and depending on the destination country and purpose of the transfer of funds, strictor restrictions could be applicable.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants are generally enforceable. If a franchisee breaches confidentiality covenants, a franchisor may seek compensation for the damages caused by such violation or seek a preliminary injunction to avoid any damages in advance.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Under article 1 of the Civil Code, there is a general duty to act in good faith. In addition, if an agreement is unreasonably advantageous to one party, it can be deemed void because it is against good public policy under

article 90 of the Civil Code. These clauses affect franchise relationships in various ways. One area where the duty to act in good faith plays an important role is with regard to the franchisor's obligation to disclose information. A court has construed that a franchisor has an obligation to provide prospective franchisees with accurate and adequate information so that they can make decisions (Fukuoka High Court, 31 January 2006, *Shin Shin Do* case, Kyoto District Court, 1 October 1991).

In addition, courts use article 90 of the Civil Code to limit liquidated damages. For example, in the *Honke Kamadoya* case (Kobe District Court, 20 July 1992), a court stated that liquidated damages of an amount equal to 60 months' loyalty payment were significantly out of balance with the expected amount of damages; consequently, the liquidated damages were void to the extent that they went beyond a reasonable amount of damages because such amount was against good public policy.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

In principle, a franchisee would not be protected as a consumer for the purpose of consumer protection laws because the franchisee is doing business and therefore a business operator. For example, the Consumer Contract Act (Act No. 61 of 2000) defines a 'consumer' as any natural person excluding a natural person who becomes a party to a commercial contract to engage in commercial endeavours. Nevertheless, as demonstrated by the courts' inclination to protect franchisees (eg, the doctrine of the destruction of a relationship of mutual trust), depending on the case, franchisees could be protected by interpretations of the Civil Code or other laws.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

There is no clear requirement that disclosure documents need to be in Japanese, but since the disclosure obligation is imposed so that prospective franchisees have sufficient information and understand the franchise well, it is prudent to prepare these documents in Japanese. There is no requirement that franchise agreements should be in Japanese.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

Clauses related to territories, payment of fees, procurement of goods or services, non-compete obligation, governing law and dispute resolution are usually included in franchise contracts. For further details, it would be useful to refer to the matters that are subject to disclosure obligation under the Medium and Small Retail Commerce Promotion Act (Act No. 110 of 1973).

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Assuming that both parties to the dispute are doing business in Japan, unless otherwise provided in an agreement, a dispute regarding a franchise relationship may be brought to a district court that has jurisdiction over the dispute under the Code of Procedure (Act No. 109 of 1996). In every prefecture, one or more district courts exist. Decisions by district courts may be appealed to a competent High Court, and then to the Supreme Court. In addition to litigation in a courtroom, arbitration is possible if the parties so agree.

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Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

If the parties agree, it is possible to designate a foreign governing law in franchise contracts. In these cases, the enforceability of the contract is assessed under the specified foreign law. Nonetheless, compulsory regulations such as the disclosure obligations under the Medium and Small Retail Commerce Promotion Act (Act No. 110 of 1973) and the requirements under the Antimonopoly Act must be complied with by all parties to the contract.

Arbitration – advantages for franchisors

44 | What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

Foreign franchisors' principal advantage in choosing arbitration is that the proceedings can be conducted in English or any other language as agreed in the franchise agreement. In case of litigation in Japanese courts, the language must be Japanese. In addition, arbitrators may be more familiar with franchise business than Japanese judges. The principal disadvantage of arbitration is the generally higher costs due to fees for the arbitrators and the fact that the number of arbitrators familiar with the franchise business in Japan as well as in the jurisdiction where the foreign franchisor mainly operates may be limited.

National treatment

45 | In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Because of certain restrictions on foreign business entities and foreign investment (eg, the Foreign Exchange and Foreign Trade Act (Act No. 228 of 1949) (FEFTA) and industry-specific laws), foreign franchisors could face different regulations. For example, certain technical licences could be subject to regulatory filing under the FEFTA, depending on the contents of the licence. In addition, if the industry of the franchise is regulated by specific laws, such laws may treat foreign franchisors differently.

UPDATE AND TRENDS

Legal and other current developments

46 Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

The Japan Fair Trade Commission conducted an industry survey about trade practices between franchisors and franchisees of convenience stores. Based on that research, the results of which were released in September 2020, its Guidelines Concerning the Franchise System (the Franchise Guidelines) were amended. For example, regarding 24/7 operations, the amended Franchise Guidelines recommend disclosing information about shortages of manpower, rising labour costs or other information that may have adverse effects on the management of the franchisee. The Franchise Guidelines also clarify that it could constitute a breach of the Act on Prohibition of Private Monopolisation and Maintenance of Fair Trade (Act No. 54 of 1947) if the franchisor refuses to discuss the shortening of operational hours with the franchisee, although it is contractually permissible by mutual consent.

In addition, the amendment to the Enforcement Regulation of the Medium and Small Retail Commerce Promotion Act (Act No. 110 of 1973) came into force on 1 April 2022. This amendment requires the disclosure of income and expenditure of franchisees with similar local conditions. The Japan Franchise Association updated its guidelines about disclosure documents to give examples about information to be disclosed in relation to the additional disclosure requirements.

Malaysia

Jin Nee Wong and Siau Kee Pua
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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Franchising is very common and popular in Malaysia, and is considered one of the most effective and successful methods of business growth and expansion. Common sectors include food and beverages, education and learning centres, health and wellness, retail, and services. The halal franchise business is gaining momentum in Malaysia and offers good prospects in the international markets.

The Malaysian government strongly believes that the franchise industry plays a pivotal role in contributing to the national gross domestic product and, as such, it has taken a leading role in developing and nurturing the growth of the franchise industry. The government, through the Ministry of Domestic Trade and Consumer Affairs (MDTCA) together with Perbadanan Nasional Berhad (Pernas) and supported by the Malaysian Franchise Association (MFA), has introduced and implemented many programmes and initiatives that are designed to provide a conducive environment to accelerate the development of competitive and high-quality 'fran-preneurs', and to create strategic network and alliances with the private sectors. The various incentives and schemes for franchisors and franchisees include the Franchise Financing Scheme, the Franchise Development Assistance Fund, the Small Franchise Financing Scheme, and the Franchise Development and Local Franchise Product Development Programme.

In the 2022 budget, the Malaysian government, through Pernas, has allocated 74 million ringgit to those who are interested in becoming franchise entrepreneurs, among others, to provide training programmes and business guidance and a simple zero financing scheme for the first six months together with a moratorium.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The MFA was formed in 1994 to support the implementation of government programmes that promote entrepreneurship through franchising. The MFA provides a useful platform to engage with industry players, government agencies and supporting institutions. It also functions as a resource centre for the public, as well as existing and prospective franchisors and franchisees. The MFA provides input and liaises with government departments and agencies on matters concerning franchising. In addition to setting guidelines and standards of ethical practice among its members, it serves as a forum through which the expertise and experiences of members may be exchanged. The MFA also conducts seminars, exhibitions and educational programmes on franchising.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

In Malaysia, a business may exist in a number of different forms, including sole proprietorships, partnerships (including a limited liability partnership) and companies or representative, regional or branch offices of foreign companies. The principal form of business organisation that is most relevant and common to a typical franchisor would be a private limited company.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

Where incorporation of a company is concerned, the relevant laws are the Companies Act 2016 and the Companies Regulations 2017, which came into force on 31 January 2017 (except for certain provisions including corporate voluntary arrangements and judicial management), repealing the Companies Act 1965. The relevant agency is the Companies Commission of Malaysia (SSM).

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

The Companies Act 2016 and the Companies Regulations 2017 (the 2016 Act) have simplified the company incorporation and decision-making process by introducing Superform – a single, electronic incorporation template. All incorporation and registration procedures are processed through SSM's online portal, MyCoID 2016. A notice of registration serves as conclusive evidence of incorporation. This is intended to reduce incorporation, maintenance and operational costs.

Briefly, the requirements for incorporating a company with the SSM and maintaining the company are as follows:

- the applicant must first apply to the SSM to confirm the availability of the proposed company name (section 27(1) of the 2016 Act);
- if the proposed name is available, the application will be approved and the name will be reserved for the applicant for a period of 30 days; and
- the applicant must then lodge an application containing the following particulars:

- the name of the proposed company;
- whether the company is private or public;
- the nature of business of the proposed company;
- the address of the registered office;
- the name, identification, nationality and the ordinary place of residence of every person who will be a member of the company and, where any of these persons is a body corporate, the corporate name, place of incorporation, registration number and the registered office of the body corporate;
- the name, identification, nationality and the ordinary place of residence of every person who will be a director;
- the name, identification, nationality and the ordinary place of residence of the secretary;
- in the case of a company limited by shares, the details of class and number of shares to be taken by the member; and
- any other information that the Registrar of Companies may require.

Restrictions on foreign investors

6 | What restrictions apply to foreign business entities and foreign investment?

Generally, a foreign company cannot carry on business in Malaysia unless it incorporates a company as its subsidiary, sets up a branch office or registers a representative office in Malaysia. In certain circumstances, a foreign company may wholly own a Malaysian company; for example, if the foreign company has been granted Multimedia Super Corridor status or has been granted the status of International Procurement Centre, Operational Headquarters or other special statuses that can be granted by various ministries.

The Guidelines for Foreign Participation in the Distributive Trade Services (the Guidelines), among others, include:

- the opening of new branches;
- the relocation or expansion of existing branches or outlets;
- buying or taking over of other operators' outlets; and
- the purchase of land, premises and assets prior to obtaining approval or a licence from the local authority to operate distributive trade activities.

Distributive traders include wholesalers, retailers, franchise practitioners, direct sellers, product manufacturers and suppliers who channel their goods in the domestic market and commission agents or other representatives, including those of international trading companies of all nationalities.

The Guidelines impose a general requirement that all proposals for foreign participation in distributive trade must obtain the approval of the Distributive Trade Committee of the Ministry of Domestic Trade and Consumer Affairs.

One of these approvals is known to many as a wholesale and retail trade (WRT) licence, which must be obtained by all foreign-owned companies dealing in the wholesale, retail, trading, import or export, restaurant and franchise businesses before they can operate in Malaysia. In order for a foreign company to apply for a WRT licence, the general requirement is that the company must have at least a minimum paid-up capital of 1 million ringgit.

The Guidelines provide that all franchise businesses with foreign equity must be incorporated locally under the 2016 Act.

Taxation

7 | What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

All of a company's or individual's income that is accrued in, derived from or remitted to Malaysia is liable to tax. A corporation is resident in Malaysia if its management and control are exercised in Malaysia.

During the tabling of Malaysia's Budget 2022, the government proposed the removal of the tax exemption on foreign-sourced income (FSI) received by Malaysian resident taxpayers. The proposal was enacted into law via the Finance Act 2021, which took effect from 1 January 2022.

However, shortly before the Finance Act 2021 was gazetted on 31 December 2021, the Ministry of Finance issued a press release on 30 December 2021 announcing that the government will continue to exempt from tax the following types of FSI received by resident individual taxpayers for five years, namely from 1 January 2022 to 31 December 2026 (subject to the criteria and guidelines issued by the Inland Revenue Board of Malaysia):

- dividend income received by resident companies and limited liability partnerships; and
- all classes of income received by resident individuals, except for resident individuals who carry on business through a partnership.

Non-resident taxpayers (individuals, companies, etc) will continue to be exempted from income tax on FSI.

For the year of assessment 2022 (YA 2022), the standard corporate tax rate is 24 per cent, while the rate for resident small and medium-sized companies (namely companies incorporated in Malaysia with paid-up capital of 2.5 million ringgit or less)(SMEs) is 17 per cent on the first 600,000 ringgit, with the balance taxed at the 24 per cent rate. Income tax is imposed at progressive rates up to 30 per cent for resident individuals. Non-residents are taxed at a flat rate of 30 per cent.

For the YA 2022 only, a special one-off tax will be imposed on non-SMEs that generated high profits during the covid-19 pandemic, at the rate of 33 per cent on the portion of chargeable income in excess of 100 million ringgit. For clarity, FSI received in Malaysia in the YA 2022 is exempted from this tax.

Apart from income tax, there are other direct taxes such as stamp duty and real property gains tax, and indirect taxes such as excise duty, import duty and export duty.

A withholding tax is charged to non-resident companies or individuals that derive income from a Malaysian source on payments for services rendered, technical fees or other payments including royalties and interest.

Sales tax and service tax came into force on 1 September 2018, replacing the goods and services tax under the Goods and Services Tax Act 2014. The implementation of sales tax and service tax are primarily governed under the Sales Tax Act 2018 and Service Tax Act 2018 respectively. Sales tax is charged on all goods manufactured in or imported into Malaysia unless exempted. It is an ad valorem tax whereby different rates (ie, 5 per cent, 10 per cent or exempted) apply to different groups of taxable goods. On the other hand, service tax is imposed on any taxable services provided in Malaysia by a registered person in carrying on his or her business. Some of the taxable services include provision of accommodation, food and beverages, telecommunication services, services in health and wellness centres and professional services. The service tax rate is 6 per cent for all taxable services.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

The Employment Act 1955 governs all matters relating to employment. It applies to all employees whose wages do not exceed 2,000 ringgit per month. All other workers are governed by their employment contracts and common law principles developed through case law. Such common law principles impose certain basic obligations on employers and employees.

The risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor is minimal. Notwithstanding this, to further reduce any risk, it should be expressly provided in the franchise agreement between the franchisor and franchisee that no such relationship exists, and the franchisee should display appropriately worded signage at the franchised location clearly indicating its status as an independent undertaking. The franchisor may wish to adopt the following practices to avoid being seen as exercising controls over the employees of its franchisees and, accordingly, to minimise the risks:

- the franchisor should not be involved in the management of the franchisees' employees or the day-to-day operations of the franchised outlets;
- the franchisor should not control the employment terms of the franchisees' employees, for example, by setting the wages, termination, promotion or demotion of the employees; and
- the franchisor should not set employment policies for franchisees' employees.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

Under the Trademarks Act 2019 (TMA) (which repealed the Trademarks Act 1976), trademarks (including service marks) can be protected with the Malaysian Intellectual Property Office by way of registration. Registration is the best method of protection, as it provides an exclusive right to use the trademark for the goods or services covered by the registration in Malaysia. The TMA came into force on 27 December 2019.

Registration of a trademark is available to an individual, partnership or company that intends to use or is using the trademark in the course of trade in Malaysia. All registered owners, whether local or foreign, are entitled to the same protection. Malaysian law also accords rights to unregistered trademarks or service marks under common law through the tort of passing-off. It is possible to register a trademark that is in a foreign language. A person's registration as the registered proprietor of a trademark in respect of any goods or services under the TMA shall, if valid, give or be deemed to have given to that person the exclusive right to the use of the trademark or service mark in relation to the goods or services in the whole of Malaysia, subject to any conditions, amendments, modifications or limitations entered in the register.

Under the TMA, no one is entitled to sue for infringement unless the trademark has been duly registered. The registered proprietor's exclusive right to the mark is effective from the date of registration, which is deemed to be the date that the application to register is filed.

Malaysia acceded to the Paris Convention on 1 January 1989. Applicants may claim priority from their basic application in a member country of the Paris Convention, provided that the application in Malaysia is filed within six months of the date of basic application. Malaysia is also a signatory of the Nice Agreement and adopts the 11th edition of the Nice Classification of Goods and Services and the TMclass. Malaysia also acceded to the Madrid Protocol on 27 September 2019. With the implementation of the Madrid Protocol in the new TMA, trademark owners in Malaysia are now able to file trademarks in over 128 designated member countries by filing one international trademark application with a single set of fees. Similarly, trademark owners in a member state can designate Malaysia in an international trademark application.

Know-how, trade secrets and confidential information are generally protected by secrecy agreements, undertakings, or both, that bind the recipient personally. Where no such agreements or undertakings exist, the common law of breach of confidence applies. The requirements for an actionable breach of confidence are:

- the information itself must 'have the necessary quality of confidence about it';
- the information must have been imparted in circumstances importing an obligation of confidence; and
- there must be unauthorised use of that information, to the detriment of the party communicating it.

The Franchise Act 1998 (as amended by the Franchise (Amendment) Act 2020) (FA) expressly provides for the protection of confidential information.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

Most franchised outlets are leased or tenanted properties rather than being owned by franchisees or franchisors. In Malaysia it is common for owners to enter into a tenancy agreement for a period not exceeding three years so as to avoid having to register the lease at the relevant land office. One has to fall back on general contract law – the Contracts Act 1950 – for much of the Malaysian law governing landlords and tenants.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

The Malaysian Competition Act 2010 (CA) came into force on 1 January 2012. The Malaysia Competition Commission (MyCC) is an independent body established under the Competition Commission Act 2010 to enforce the CA. MyCC issued numerous guidelines, including the Guidelines on Anti-Competitive Agreements and Market Definition (which came into force in 2012) as well as the Guidelines on Intellectual Property Rights and Competition Law (which came into force on 5 April 2019) that set out a list of factors and circumstances that MyCC may consider in deciding whether certain agreements are anticompetitive.

These guidelines are non-exhaustive and are not a substitute for the CA or any regulations made thereunder, and may be revised should the need arise. In applying these guidelines, the facts and circumstances of each case must be considered. MyCC has indicated that it has plans to issue specific guidelines dealing with franchise agreements but no specific timeline has been given.

The CA prohibits two broad categories of anticompetitive activities: 'anticompetitive agreements' and 'abuse of a dominant position'. A franchise agreement, which is a vertical agreement, would be prohibited by the CA if it has the goal or effect of significantly preventing, restricting or distorting competition in any market for goods or services (section 4(1) of the CA). To this end, MyCC not only examines the common intentions of the parties to an agreement but also assesses the aims pursued by the agreement in light of the economic context of the agreement. If the goal of an agreement is highly likely to have a significant anticompetitive impact, then MyCC may find the agreement to have an anticompetitive goal. If an anticompetitive goal is not found, the agreement may still

breach the CA if there is an anticompetitive effect. In general and as a starting point, MyCC adopts the following basis for assessing whether an anticompetitive effect is 'significant'. Anticompetitive agreements are not considered significant if, as laid out in paragraph 3.4 of the Guidelines on Anti-Competitive Agreements:

- the combined market share of the parties to the agreement is less than 20 per cent of the relevant market; and
- the parties to the agreement are not competitors and their individual market share in any relevant market is not more than 25 per cent.

It should be noted that the CA does not apply to agreements that comply with legislative requirements. Thus, if certain provisions in the franchise agreements are inserted to comply with the FA (for example, the provision against the franchisee to conduct a similar business during the franchise term and for two years thereafter), arguments could be made that they are not anticompetitive.

Apart from these guidelines, there are currently no reported decisions that would be instructive as to how MyCC or the Malaysian courts would consider various contractual restrictions in franchise agreements. In applying these guidelines, the facts and circumstances of each case must be considered.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

Under section 4 of the Franchise Act 1998 (as amended by the Franchise (Amendment) Act 2020) (FA), the statutory definition of a franchise is a contract or an agreement, either expressed or implied and whether oral or written, between two or more persons, by which:

- the franchisor grants to the franchisee the right to operate a business according to the franchise system as determined by the franchisor during a term to be determined by the franchisor;
- the franchisor grants the franchisee the right to use a mark, or a trade secret, or any confidential information or intellectual property owned by the franchisor or relating to the franchisor, and includes a situation where the franchisor who is the registered user of, or is licensed by another person to use, any intellectual property grants such right that it possesses to permit the franchisee to use the intellectual property;
- the franchisor possesses the right to administer continuous control during the franchise term over the franchisee's business operations in accordance with the franchise system; and
- in return for the grant of rights, the franchisee may be required to pay a fee or other form of consideration.

To fall within the purview of the FA, the arrangement must consist of all of the above elements and the franchisee must operate the business separately from the franchisor and the relationship must not at any time be regarded as a partnership, service contract or agency. This arrangement would then be regarded as a franchise, whether it is called a franchise or otherwise.

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

The Franchise (Amendment) Act 2020 (Amendment Act), which made certain changes to the FA, came into force on 28 April 2022. The Franchise Development and Direct Sales Division of the Ministry of Domestic Trade and Consumer Affairs is the governmental agency that regulates the offer and sale of franchises, and the approval or registration of franchisors and franchisees in Malaysia.

If a person is able to demonstrate that his or her business model does not fall within the definition of a franchise, in that it does not satisfy all the ingredients in the definition of the franchise, such business would not come under the purview of the FA.

Under the Franchise (Exemption) Order 2004, any person who has sold a franchise in Malaysia or to any Malaysian citizen prior to the commencement of the FA (8 October 1999) would be exempted from complying with section 54 of the FA, namely the requirement to submit an application to the registrar.

Pursuant to section 58 of the FA, the Minister of Domestic Trade and Consumer Affairs may, under the authority granted by an order published in the Malaysian Gazette, exempt (subject to such conditions as he or she deems fit to impose) any person or class of persons, business or industry from any or all of the provisions of the FA. To date, the only industry that is exempted under this provision is the petroleum industry.

Under the Franchise (Exemption) Order 2001 (PU(A) 27/2001), the minister has exempted from the provisions of the FA:

- petrol station businesses; and
- any other business operating together with a petrol station business, subject to the condition that the business operating together with a petrol station business:
  - is operated in the same premises as the petrol station; and
  - is franchised by the same petroleum industry that franchises the petrol station business.

Principal requirements

14 | What are the principal requirements governing the offer and sale of franchises under the relevant laws?

The Malaysian government has long been aware that franchising is one of the fastest ways to create and increase the number of local entrepreneurs and promote growth in the franchise industry in Malaysia. Essentially enacted to facilitate and monitor the growth of the franchise industry, the FA applies throughout Malaysia and to the sale of any franchise in Malaysia. Pursuant to the FA, franchisors (including local franchisors, local master franchisees and foreign franchisors) are required to seek approval from or register with (or both) the Franchise Development and Direct Sales Division of the Ministry of Domestic Trade and Consumer Affairs before they can offer to sell or buy franchises in Malaysia. The Amendment Act, which came into force on 28 April 2022, prescribes five years as the period of effectiveness for a franchise registration, which is applicable to all franchisors, regardless of whether they are registered before or after 28 April 2022. After such period of effectiveness, franchise registrations may be renewed by applying to the Ministry of Domestic Trade and Consumer Affairs (MDTCA) in a prescribed format with payment of the requisite renewal fee.

Further, a franchisee of a foreign franchisor must register the franchise before commencing the franchise business. A franchisee of a local franchisor or a local master franchisee must register the franchise within 14 days of signing the franchise agreement. The Amendment Act provides that failure to comply with such registration is a criminal offence under the FA.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

One requirement that is highly unpopular among franchisors and local master franchisees is that they must operate their own outlets profitably for at least three years before they are permitted to appoint sub-franchisees. While this requirement is not expressly provided in the FA or any of the regulations, the authorities have taken the view that it is one of the prescribed requirements in law due to section 7 of the FA and the prescribed format of the disclosure document form pertaining to the documents required for franchise registration, which would cover the submission of audited financial statements for the past three years.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

Although the FA does not expressly restrict the manner in which a franchisor recruits franchisees or selects its suppliers, the government does exercise some form of control and impose certain conditions (when granting its approval during the approval application or registration process). For instance, if the territorial area granted to a potential franchisee is considered to be too small or restrictive, the Registrar of Franchises (ie, the Franchise Development and Direct Sales Division of the Ministry of Domestic Trade and Consumer Affairs (MDTCA)) would request the applicant to extend the territorial right to a larger area (usually by reference to a radius in kilometres). The Registrar of Franchises may also require the franchisor to submit a list of its suppliers in granting approvals. If the franchisor has not shown profitability or healthy growth in its financial statements for the franchise business, the Registrar of Franchises is likely to refuse the approval application or registration on the basis that the franchisor is not ready to sell its franchise systems to franchisees in Malaysia.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

In the case of a sub-franchising structure (namely where the foreign franchisor appoints a local master franchisee who then, in turn, appoints sub-franchisees in Malaysia), the local master franchisee is the one providing pre-sale disclosures to sub-franchisees. The local master franchisee must disclose the fact that it is a master franchisee, not the franchisor of the franchise in question, and that the trademarks belong to the foreign franchisor. As the foreign franchisor should have submitted an application for the franchise prior to the sale of the franchise to the master franchisee, all relevant information pertaining to its operations and experiences would have been provided to the Registrar of Franchises (ie, the Franchise Development and Direct Sales Division of the MDTCA) during such application.

Section 16 of the FA provides that an updated disclosure document must be filed annually by the franchisor, within six months of the end of the financial year of the franchise business. This requirement appears to be inconsistent with the amended form (BAF1) whereby it is provided that the annual report must be filed 30 days after the registration anniversary. Since the Amendment Act and its subsidiary legislation are relatively new, clarification is being sought from the MDTCA.

Pre-contractual disclosure – content

18 | What information is the disclosure document required or advised to contain?

The disclosure documents contain a large amount of information, including but not limited to the following:

- the name, business address and type of business, including the franchisor's business experience;
- details of the intellectual property rights granted to the franchisee;
- the types and amount of fees imposed on franchisees;
- details of other financial obligations, including advertising, training or service fees payable;
- whether the franchisee is required to purchase equipment or products from the franchisor or from a source designated by the franchisor and, if so, to identify the source;
- the obligations of the franchisor, prior to operating or during operation, in determining the business site;
- the territorial rights granted to the franchisee and circumstances of when the boundary of the territory may be altered; and
- the franchise term, and the terms for renewal and termination of the agreement by the franchisor or franchisee, and the parties' obligations upon termination.

The franchisor is required to submit audited financial statements for the past three financial years and financial forecasts for five years. The requirement for financial forecasts for five years (instead of three years previously) was amended pursuant to the Franchise (Forms and Fees) (Amendment) Regulations 2007, which came into force on 15 December 2007.

Pre-sale disclosure to sub-franchisees

19 | In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

A franchisor (including foreign and local franchisors, and master franchisees) must submit to a franchisee a copy of the franchise agreement, together with the relevant disclosure documents, at least 10 days before the franchisee signs the franchise agreement with the franchisor. Such disclosure documents include documents submitted by the franchisor for registration of the franchise, which provide a full overview of the franchise business system that will be franchised to the franchisee. A franchisor's failure to submit these documents is an offence under the FA. If there is any material change in the disclosure documents, they must be amended and filed with the Franchise Development and Direct Sales Division of the MDTCA (Registrar of Franchises). The franchisor must submit an annual report to the Registrar of Franchises within the prescribed timeframe. Failure to do so is an offence. The report must contain updated disclosure documents. The specific timeframe for filing the annual report is subject to further clarification from the MDTCA, in light of the inconsistency between the newly amended annual report form as set out in the Franchise (Forms and Fees) (Amendment) Regulations 2022, which indicates the timeframe to be that of 30 days from registration anniversary as compared to within six months of the end of the financial year of the franchise business provided under the existing Section 16 of the FA (which strictly speaking should prevail).

Due diligence

20 What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

Both franchisors and franchisees should undertake due diligence before entering into a franchise relationship. Although there is no specific process or exhaustive checklist for the due diligence, it can entail taking a number of action items or steps, namely from checking if the franchise in question has been registered and approved by the Franchise Development and Direct Sales Division of the MDTCA to operate in Malaysia, to speaking with other franchisees in the network and conducting desktop research online. An important and relevant source of information would be the disclosure document and franchise agreement, which must be provided by the franchisor at least 10 days before the franchisee signs the franchise agreement. The franchisor should conduct a company or business search (on the legal entity) and credit checks on the franchisee (or its key person).

Failure to disclose – enforcement and remedies

21 What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

It is a criminal offence under the FA to make false statements of material fact or to omit a material fact that renders the statement misleading in the disclosure documents. It is also a criminal offence if the franchisor fails to submit copies of the disclosure documents to the franchisee at least 10 days before the franchisee signs the franchise agreement. Failure to update the disclosure documents when submitting an annual report would also amount to an offence.

In the event of any violations of disclosure requirements, franchisees may lodge a complaint against the franchisor with the Registry of Franchises.

A contract induced by misrepresentation is voidable at the choice of the innocent party. The innocent party may rescind the contract by giving notice to the other party. Any party that has received any advantage under the contract is bound to restore the innocent party to the situation it was in before the violation occurred, or compensate the other party.

The general rule governing the extent of damages payable is laid down in section 74 of the Contracts Act 1950:

> *When a contract has been broken, the party who suffers by the breach is entitled to receive, from the party who has broken the contract, compensation for any loss or damage caused to him thereby, which naturally arose in the usual course of things from the breach, or which the parties knew, when they made the contract, to be likely to result from the breach of it.*

Failure to disclose – apportionment of liability

22 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Unless the franchisor is a party to the contract between the master franchisee and sub-franchisees, the franchisor is not liable to the sub-franchisees as there is no privity of contract between them. Nevertheless, in most agreements between the franchisor and sub-franchisor, there would be appropriately drafted warranty and indemnity clauses to address this issue. Individual officers, directors and employees of the franchisor or sub-franchisor, as the case may be, are not liable unless they are personally party to the contract or if the other party is able to lift the corporate veil to impute liability to them personally.

General legal principles and codes of conduct

23 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

Apart from the FA, the provisions in the Contracts Act 1950 would be relevant and may affect the offer and sale of franchises.

Fraudulent sale

24 What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

If the franchisor engages in any act, practice or course of business that operates or would operate as a fraud or deceit upon any person in relation to an offer to sell or a sale of a franchise, the franchisor commits a criminal offence under the FA that will entitle the franchisee to lodge a complaint against the franchisor with the Registrar of Franchises. If convicted, the franchisor may be liable for a maximum fine of 250,000 ringgit for the first offence. Further, the court may declare the franchise agreement null and void, and may order the franchisor to refund any payments obtained from any franchisee, prohibit the franchisor from making any new franchise agreement or prohibit the franchisor from appointing any new franchisee.

FRANCHISE CONTRACTS AND THE FRANCHISOR/ FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The Franchise Act 1998 (as amended by the Franchise (Amendment) Act 2020) (FA), which came into force on 28 April 2022, is the most specific and relevant law. The contractual relationship of the parties would also be governed by the contractual terms of the franchise agreement and, accordingly, the provisions of the Contracts Act 1950 would be relevant.

Operational compliance

26 What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

In order for the franchisor to ensure and enforce stringent compliance by franchisees with the operational compliance and standards of its franchise system, the franchisor would usually incorporate provisions such as inspection with or without prior notice, audit rights, a mystery shopper programme and reporting requirements in the franchise agreements. In the event a franchisee fails to meet the required standards, the franchisor would give the franchisee a specific time frame to remedy the failure, failing which the franchisor may be entitled to terminate the franchise agreement. In addition, the franchisor should ensure that the operations manual, policies and procedures for other operational compliance and standards are incorporated into the franchise agreements by reference.

Other mechanisms may include the installation of web-based accounting and point of sale systems to enable the franchisor to monitor the franchisee's compliance closely without having to inspect the outlet physically. It is also important for the franchisor's team members to visit the outlets periodically to keep the franchisees on their toes, and continuously support and train the franchisee on the job to improve performance.

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

Although a franchisor may not unilaterally change the terms of the franchise agreement without the prior consent of the franchisees, the franchisor may state in the franchise agreement that the contents or terms of the operations manual may be updated, varied or amended by the franchisor from time to time and they must be adhered to by the franchisee.

Any material changes to the disclosure documents after the registration of the franchise should be submitted for approval by the Franchise Development and Direct Sales Division of the Ministry of Domestic Trade and Consumer Affairs (MDTCA). Such material changes may cover operational terms and standards of the franchise business and franchise system.

Policy affecting franchise relations

28 | Do other government or trade association policies affect the franchise relationship?

As well as the policies expounded by the Franchise Development and Direct Sales Division of the MDTCA, other government policies such as the Distributive Trade Guidelines may have an impact on the franchise industry and franchise relationship.

Apart from the MDTCA, the Perbadanan Nasional Berhad (Pernas), an agency under the Ministry of Entrepreneur and Cooperatives Development with the mandate to lead the development of Malaysia's franchise industry in line with the National Entrepreneurship Policy (NEP) 2030, aims to develop the franchise industry while increasing the number of franchise entrepreneurs through its expertise in providing quality services and products. Pernas plays a pivotal role in identifying and acquiring foreign franchises and launching them in Malaysia, and acquires master franchisee rights to famous foreign brands such as Gloria Jean's Coffee. Pernas also provides financial assistance to bumiputera entrepreneurs (that is, entrepreneurs from an indigenous origin in Malaysia) venturing into franchise businesses via equity investment and franchise business financing. Pernas has set up a franchise academy to conduct various franchise-related training programmes, and provides guidance and special schemes for franchisors and franchisees in Malaysia. Pernas introduced the Be Your Own Boss (BYOB) project in 2021, an initiative providing a holistic and competitive entrepreneurship programme targeting bumiputera youths and women who want to venture into entrepreneurship, especially in franchise and pre-franchise businesses.

The Malaysian Franchise Association (MFA) – which was formed to support the implementation of government programmes to promote entrepreneurship through franchising – serves as a useful resource centre for current and prospective franchisors and franchisees, as well as for the media and public. The MFA provides input and liaises with government departments and agencies on matters concerning franchising. In addition to setting guidelines and standards of ethical practice among its members, it serves as a forum through which the expertise and experiences of members may be exchanged. The MFA also conducts seminars, exhibitions and educational programmes on franchising.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

A franchisor may only terminate a franchise relationship under certain circumstances prescribed by the FA that would have been incorporated into the franchise agreement. For instance, section 31 of the FA provides that no franchisor may terminate a franchise agreement before the expiration date, except for good cause.

Good cause includes:

- the franchisee's failure to comply with any terms of the franchise agreement; and
- the franchisee's failure to remedy a breach committed within the period stated in a written notice given by the franchisor, which must not be less than 14 days.

Good cause also includes – without the requirement of notice and an opportunity to remedy the breach – instances in which the franchisee:

- assigns the franchise rights for the benefit of creditors or a similar disposition of the assets of the franchise to any other person;
- voluntarily abandons the franchised business;
- is convicted of a criminal offence that substantially impairs the goodwill associated with the franchisor's mark or other intellectual property; or
- repeatedly fails to comply with the terms of the franchise agreement.

In addition, section 32 of the FA may restrict the franchisor's ability to terminate a franchise relationship, in that a franchisor commits an offence if it refuses to renew a franchise agreement or extend a franchise term without compensating a franchisee either through repurchase or by other means at a price to be agreed between the franchisor and the franchisee, after considering the diminution in the value of the franchised business caused by the expiration of the franchise where:

- the franchisee is barred by the franchise agreement, or by the refusal of the franchisor at least six months before the expiration date of the franchise agreement, to waive any portion of the franchise agreement that prohibits the franchisee from continuing to conduct similar business under another mark in the same area subsequent to the expiration of the franchise agreement; or
- the franchisee has not been given written notice of the franchisor's intention not to renew the franchise agreement at least six months prior to the expiration date of the franchise agreement.

Notwithstanding these provisions of the FA, a franchise term may be terminated before the expiry of the minimum term of five years in the following circumstances:

- where both parties mutually agree to terminate the franchise agreement; or
- where a court has decided that there are certain conditions in the franchise agreement that merit the agreement being terminated earlier than the minimum term.

Nothing in the FA precludes the franchisor from taking over and operating the business formerly operated by the franchisee after the franchise agreement has been terminated or has expired.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

Section 31 of the FA expressly provides for good cause circumstances in which a franchisee may terminate a franchise relationship.

A franchise agreement must provide for a cooling-off period of not less than seven working days during which the franchisee has the option to terminate the agreement and be refunded all monies paid to the franchisor, save for reasonable expenses incurred by the franchisor in preparing the agreement (sections 18(4) and 18(5) of the FA).

A franchisee may also terminate the franchise agreement before the expiry of the term with the mutual consent of the parties (section 33 of the FA).

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

Most, if not all, franchise agreements contain renewal provisions and conditions for renewing the franchise agreements. In addition, there are provisions in the FA that regulate the renewal and non-renewal of franchise agreements. If the parties agree that there will be no change to the terms of the franchise agreement during the renewal period, it will be sufficient for the parties to execute a side letter without having to enter into a fresh agreement for the renewal term.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

The franchisor may refuse to renew the franchise agreement with a franchisee if:

- the franchisee has breached the terms of a previous franchise agreement;
- the franchisee fails to give written notice to the franchisor to renew the term at least six months prior to the expiry date;
- the franchisee is compensated through repurchase or by other means at a price to be mutually agreed between the parties after considering the diminution in the value of the franchised business; or
- the franchisor has waived the section of the franchise agreement that prohibits the franchisee from conducting similar business under another mark in the same area subsequent to the expiration of the franchise agreement.

Unless the franchisor is able to establish any of the above circumstances, it appears in section 32 of the FA that the franchisor must renew the franchise agreement for another period if the franchisee has applied for such renewal. Apart from the renewal of the franchise agreement, it should also be noted that the franchise agreement must be extended by the franchisor if the franchisee gives notice to extend the franchise agreement. Such an extended term must contain conditions that are similar or not less favourable than the conditions in the current franchise agreement. The term 'another period' in this provision seems to suggest that the extended period for a franchise agreement based on similar or not less-favourable terms is limited to one additional term from the initial term.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes, provided that such restrictions are contained in the franchise agreement.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

Although there is no express provision in the FA or any other law affecting the nature or amount of fees, there is a general provision in the FA that provides that a franchisor and a franchisee, in their dealings with one another, shall avoid:

- substantial and unreasonable overvaluation of fees and prices;
- conduct that is unnecessary and unreasonable in relation to the risks to be incurred by one party; and
- conduct that is not reasonably necessary for the protection of the legitimate business interests of the franchisor, franchisee or franchise system.

In addition to the above general provision, if a franchisor requires the franchisee to pay the franchise fee before signing the franchise agreement, including a payment that is part of a franchise fee, the franchisor must state in writing the purpose of the payment and the conditions for use and refund of the monies. If the franchise agreement is terminated during the cooling-off period, the franchisor must refund all monies, including the initial fees paid by the franchisee, after deducting the reasonable expenses incurred to prepare the franchise agreement for the franchisee. The franchisor is committing a criminal offence if it fails to do so.

If the fees or other charges imposed by the franchisor are, in the opinion of the Registrar of Franchises, unreasonably or unjustifiably high, the Registrar may seek further information or explanations from the franchisor before the application or registration is approved or granted.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

The amount of interest charged on overdue payments should not be excessively high or it may not be recoverable.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There is no restriction on payments by a franchisee to a foreign franchisor in the franchisor's domestic currency (foreign currency) subject to withholding tax on royalty payments derived from within Malaysia.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Yes, they are enforceable. In addition, section 26(1) of the FA provides that a franchisee must give a written guarantee to a franchisor that the franchisee, including its directors, the spouses and immediate family of the directors (as inserted by the Franchise (Amendment) Act 2012) and its employees may not disclose to any person any information contained in the operation manual or obtained while undergoing training organised by the franchisor during the franchise term and for two years after the expiration or earlier termination of the franchise agreement. Failure to provide such a written guarantee or to comply with the guarantee provided is an offence. Apart from being an offence under the FA, in the event of the franchisee breaching confidentiality obligations, the franchisor may commence civil proceedings or proceedings regarding breach of the franchise agreement.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Under the provisions of the FA, it is provided that a franchisor and a franchisee must act in an honest and lawful manner and endeavour to pursue the best franchise business practice of the time and place. Nevertheless, failure to comply with these provisions is not an offence.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

There is no law (including the Trade Descriptions Act 2011 and Consumer Protection Act 1999) that treats franchisees as consumers for the purposes of consumer protection.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

Disclosure documents and franchise agreements may be in English. If supporting documents for franchise registration (such as those relating to the franchisor's profiles or franchise business) are not originally in English, the Registrar of Franchises may require them to be translated into English.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

Pursuant to the FA, there are various restrictions in relation to these provisions in the franchise contracts, including but not limited to:

- the duration of the franchise agreement must be at least five years;
- the franchisee must give a written guarantee that it and its employees will not carry on any other business similar to the franchise business during the franchise term and for two years after the expiry or termination of the franchise agreement; and
- the franchisor must not unreasonably and materially discriminate between franchisees where charges are offered or made for franchise fees, royalties, goods, services, equipment, rentals or advertising services if such discrimination will cause competitive harm to the franchisees.

While the FA does not impose any restrictions on the franchisees regarding soliciting other franchisees' employees, it is common for the franchisor to insert such a restriction in the franchise agreement to ensure that its other franchisees will not encounter such challenges in having their employees being solicited by other franchisees. This provides the franchisor with an option to terminate the franchise agreement of a franchisee found to be soliciting employees of other franchisees.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The Malaysian legal system is based substantially on the English legal system and the principles of common law. English judicial decisions and other Commonwealth judicial decisions are considered by the Malaysian courts, but only as a persuasive rather than conclusive authority. Although Malaysia is federally constituted, its judicial system is a single-structured system consisting of superior and subordinate courts. The superior courts are the High Court of Malaya, the High Court of Sabah and Sarawak, and the Court of Appeal. The subordinate courts are the magistrates' courts and the sessions courts. The Federal Court is the highest judicial authority in Malaysia and is the final court of appeal.

The law offers equal protection for foreigners and foreign-owned companies. Commercial disputes may be resolved by arbitration. Malaysian law gives effect to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Unlike arbitration, which enjoys statutory recognition (the Arbitration Act 2005 came into force on 15 March 2006, repealing the Arbitration Act 1952 and the Convention on the Recognition and Enforcement of Foreign Arbitral Awards Act 1985), there is no statute providing for dispute resolution by way of mediation, as is found in some other jurisdictions. Nevertheless, in recent times mediation has been increasingly encouraged as an alternative mechanism for dispute resolution.

The Registrar of Franchises (ie, the Franchise Development and Direct Sales Division of the Domestic Trade and Consumer Affairs) has also increasingly encouraged franchisors and franchisees to adopt mediation clauses in franchise agreements.

Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

It is acceptable to adopt other governing laws in Malaysia and Malaysian courts give effect to such clause in franchise agreements (unless the party challenging such a clause is able to demonstrate exceptional circumstances amounting to a strong cause that warrants a refusal to enforce the clause). That said, it may be more practical and cost-efficient to adopt Malaysian laws in franchise agreements, given that the franchised business would be conducted and the franchisees located in Malaysia.

Arbitration – advantages for franchisors

44 | What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

Arbitration is often promoted and considered as better and more efficient than litigation when resolving franchise disputes, saving both money and time. Arbitration's rules of evidence and procedures are more relaxed and simple, which usually means it takes less time and less money to bring a franchise dispute to resolution.

It is particularly attractive for foreign franchisors, as the proceedings and documents can be conducted in English. In addition to flexibility regarding the choice of arbitration location, hearing dates can be scheduled around the needs and availability of the parties involved, unlike trial dates, which are fixed by the courts and beyond the control of those involved. Arbitration proceedings are generally held in private, and parties keep the proceedings and terms of the final resolution confidential.

Despite its many benefits, arbitration may not always be the best option. In certain circumstances, it may have various drawbacks and shortcomings that do not exist in litigation. The costs may be higher than anticipated, as the arbitrators' fees, administrative fees and other expenses to be borne by the parties are higher than those incurred in litigation. The arbitrator's decision-making power is more discretionary and flexible than that of a judge and the hearing is private, meaning the

ramifications of choosing a wrong or unskilled arbitrator could be more serious. The less well-defined rules and fewer procedural safeguards adopted in arbitration may sometimes result in mistakes. Owing to the arbitrator's final and binding decision being generally unappealable (except in special circumstances), the decision can result in serious and unfortunate repercussions for one of the parties involved.

In addition, the Registrar of Franchises (ie, the Franchise Development and Direct Sales Division of the Domestic Trade and Consumer Affairs) has increasingly encouraged franchisors and franchisees to adopt mediation clauses in franchise agreements.

National treatment

45 In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Under the current practices of the Registrar of Franchises (ie, Franchise Development and Direct Sales Division of the Ministry of Domestic Trade and Consumer Affairs), foreign franchisors are only required to seek franchise approval under section 54 of the FA whereas local franchisors and local master franchisees are required to register as franchisors under section 6 of the FA.

However, under the Franchise (Amendment) Act 2020 (which has yet to come into force as at the publication date of this chapter), in addition to the requirement under section 54 of the FA, foreign franchisors will be required to obtain approval under section 6 of the FA before they are able to make an offer to sell the franchise to any person in Malaysia. While it is still unclear as to whether the foreign franchisors will be able to apply for sections 54 and 6 applications simultaneously or consecutively, this amendment in essence means the foreign franchisors will have to undertake a more tedious process than previously required. Based on the current checklist of information required for the section 6 application, it seems that the foreign franchisor may have to submit more extensive information regarding business operation, management, staff, marketing strategy, business projections, and the submission of training and operation manuals as well as the franchise agreement in the national language. Additional fees may also be incurred for the additional registration.

UPDATE AND TRENDS

Legal and other current developments

46 Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

With the coming into force of the Franchise (Amendment) Act 2020 and its subsidiary legislation (the Amendments) on 28 April 2022, the Amendments have brought along changes to the Malaysian Franchise Act 1998 (FA), some of which are discussed below.

Registration of foreign franchisors

A foreign franchisor registered under section 54 of the FA prior to 28 April 2022 shall be deemed to have been registered under section 6 of the FA (previously interpreted to cover local franchisors and local master franchisees only). Consequently, all provisions previously perceived to be applicable only to local franchisors and local master franchisees will now extend to foreign franchisors, and such provisions include, without limitation, the requirement to provide disclosure documents as part of the compulsory practice and the filing of the annual report.

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Period of effectiveness and renewal of franchise registration

The Amendments prescribe a period of five years as the period of effectiveness for franchise registrations, which is applicable to all franchisors (including local franchisors, local master franchisees and foreign franchisors), regardless of whether they are registered before or after 28 April 2022. After such effectiveness period, the franchise registrations may be renewed by applying to the Ministry of Domestic Trade and Consumer Affairs (MDTCA) in a prescribed format with payment of the requisite renewal fee.

Changes to the fee payable to the MDTCA

There is an increase in the requisite fee payable to the MDTCA (ie, registration fee) for foreign franchisors. Further, the Amendments also introduce renewal fees payable by franchisors to renew their franchise registrations.

Registration of franchisees

While a franchisee of a foreign franchisor, local franchisor or local master franchisee has been required to register with the MDTCA before it commences its franchised business since 1 January 2013, failure to comply with registration requirement is now a criminal offence under the FA with effect from 28 April 2022.

Mexico

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

For several years, many foreign franchise systems have expanded their business into Mexico. The most notable recent expansion may be found in the fuel industry, as relevant players in that field have arrived and an important number of them are operating through franchising or similar legal structures. For the first time in close to 80 years, following the legal reform regarding energy that took place in 2014, we can see in Mexican territory fuel stations operated under the Pemex trademark side by side with other (more than 30) relevant foreign and Mexican trademarks as of 2017, including companies from Mexico, the United States and Europe. Pemex continues to have a dominant position in the market, but it is expected that this stake will be reduced in the short and medium term. The fuel dispensing industry is accompanied by convenience stores, which may also operate at fuel stations through franchise or similar schemes. Consequently, the governmental decision to allow foreign and Mexican private companies to participate in fuel retail has revamped the franchise model, imposing new challenges to develop smart and practical legal and business structures in a country offering a gigantic field of opportunities for such new businesses.

Pursuant to the publications of the Mexican Franchise Association (AMF), franchises in Mexico are mainly related to services (food and beverages); however, other sectors have shown an important role, including the automotive industry, healthcare, education and entertainment, among others. Currently, there are around 1,800 franchise systems with more than 100,000 sales points all around the country. The franchise industry has created close to 1 million jobs and contributes to 6.5 per cent of the gross domestic product. The metropolitan area of Mexico City and the cities of Guadalajara, Puebla, Merida and Queretaro are the zones where more franchise systems are constantly developed.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The AMF is a private entity, the main purpose of which is the promotion and development of franchising in Mexico. It is comprised mainly of Mexican franchisors and franchisees, but the most relevant international franchise systems are not members of the AMF.

There is no legal obligation to be affiliated with the AMF and affiliation therewith does not necessarily offer any relevant benefits.

The AMF does not necessarily have an impact on laws or regulations.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

There are basically two kinds of business (commercial) entities that are regularly used by foreign franchisors to do business within Mexico by either utilising them as subsidiaries or as businesses with which franchisors may enter into franchise agreements. These entities are the stock corporation and the limited liability company. In both cases, these entities may also be of variable capital, which facilitates an increase or reduction in their corporate capital without having to comply with special formalities. The liability of the interest holders in either of these two types of entity is limited to the amount of their contributions to the corporate capital.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

The formation and corporate maintenance of business entities are governed by the General Law of Business Organisations. Different government agencies have jurisdiction over business entities depending on the activities performed by them. The main agencies governing business entities' activities are the Public Registry of Commerce (where all commercial companies must be recorded), the Administration Revenue Service for tax matters and, in the case of foreign entities, the National Registry of Foreign Investments.

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

Business entities must be incorporated before a notary public and recorded with the Public Registry of Commerce of their corporate domicile. The deed of incorporation of a business entity consists of the by-laws and articles of incorporation evidencing the initial corporate capital, the names of the holders of interest in said capital, the appointment of directors and officers and the express granting of powers of attorney to specific individuals to represent the company. The minimum number of shareholders or quota-holders to incorporate a stock corporation or a limited liability company is two. Once incorporated, any company having foreign participation in its corporate capital must be

recorded with the National Registry of Foreign Investments and the record must be renewed on a yearly basis by submitting an economic, accounting and financial report if certain thresholds on the amount of total assets, liabilities, revenues or expenses of the company are reached or exceeded.

Restrictions on foreign investors

6 What restrictions apply to foreign business entities and foreign investment?

The Mexican government's attitude towards foreign investment is, in general, an open one. Foreign investment in Mexico is regulated mainly by the Constitution and the Foreign Investment Law and its regulations, which exclusively reserve certain activities to Mexican entities without foreign investment, as well as certain activities to Mexican entities with a limit or maximum percentage of foreign investment. In general, the activities in which franchise systems participate in Mexico (such as the hospitality, restaurant, fast food, automotive and healthcare industries) are non-regulated activities; therefore, foreign investors may participate in these without any limitation or restriction. Additionally, following the energy reform implemented by the Mexican government in 2014, retailing and distribution of hydrocarbons, including gasoline and diesel, among other activities, are now open to the participation of foreign investment.

Taxation

7 What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

Federal, state and local taxes are imposed in Mexico. Federal taxes are collected by the Administration Revenue Service, while state and local taxes are collected by the treasuries of the state and municipal governments.

In accordance with article 1 of the Income Tax Law, individuals and entities are bound to pay income tax in Mexico on the following income:

- Mexican residents, with respect to all their income, without regard to the location of its source;
- non-residents with a permanent establishment in Mexico, but only with respect to the income attributable to such a permanent establishment; and
- non-residents, with respect to income coming from a source located within Mexico, when they do not have a permanent establishment within Mexico or when, having a permanent establishment, the income is not attributable to such an establishment.

In regard to this, article 2 of the Income Tax Law provides that if a foreign resident performs activities within Mexico through an individual or entity (which is different from an independent agent) it would be considered that the resident has a permanent establishment in Mexico with respect to the activities performed by the said individual or entity on behalf of the foreign resident if such an individual or entity exercises powers of attorney to execute agreements in the name of or on behalf of the foreign resident. Likewise, it is considered that a foreign resident has a permanent establishment in Mexico when the foreign resident performs activities in Mexico through an independent agent and this agent carries out the said acts outside its normal activities or course of business.

Foreign franchisors not having a permanent establishment for tax purposes in Mexico, but obtaining an income from a source located within the Mexican territory, are normally taxed on income, which is a tax of a federal nature, and is paid in Mexico by the foreign franchisor through retention or withholding made by the corresponding franchisee.

Likewise, the Income Tax Law establishes that the benefits of international tax conventions shall be applicable when the taxpayer proves residency in the corresponding foreign country. Mexico's Supreme Court of Justice has determined that the application of tax conventions holds precedence over the federal tax laws (such as the Income Tax Law). This means that a foreign franchisor, as a resident for tax purposes of its country of origin, has the right to be submitted to taxation under the terms of the corresponding tax treaty or convention, if any, instead of being submitted to the provisions of the Income Tax Law. Normally, the applicable withholding tax rates included in international tax conventions to which Mexico is a party are lower than the income tax rate provided for in the Income Tax Law. However, for franchisors to be able to obtain tax credits from their local tax authorities with respect to the taxes withheld by their Mexican franchisees, as well as to benefit from any international treaties for the avoidance of double taxation that may be in place between their country of residence and Mexico, it would be necessary for the foreign franchisors to obtain certain documentation from their franchisees, which includes evidence of payment by the franchisee to the Mexican tax authorities of the tax withheld from the foreign franchisor.

Labour and employment

8 Are there any relevant labour and employment considerations for typical franchisors?

None of the applicable Mexican laws contain provisions relating to the possibility of considering the existence of labour relations between a franchisor and a franchisee or between the employees of the franchisee and the franchisor. Nevertheless, when entering into a franchise agreement with a franchisee, the franchisor should bear in mind that under Mexican law, contracts are governed by their contents and not by how they are named. Therefore, if the franchisor incorporates or accepts the inclusion of provisions within the franchise agreement in error, that may be interpreted as constituting or creating labour relations and the Mexican labour courts would have sufficient authority to determine the labour obligations of the franchisor and find in favour of the individual franchisee or the franchisee's employees due to the nature of the agreement, regardless of its name. The courts could then penalise the franchisor for non-compliance with the labour obligations.

The most important element that could be used by a franchisee to consider the existence of labour relations would be the subordination between the franchisee and the franchisor, which means that all recommendations or guidance provided by the franchisor are in fact considered imperative instructions for the franchisee to comply with. It seems difficult for a franchisor to be considered an employer of its franchisee and certain additional elements would need to be present, such as:

- periodic payments to be made by the franchisor to the franchisee;
- material evidence of the 'instructions' periodically provided by the franchisor to its franchisee;
- the franchisee must be an individual and not an entity; and
- the franchisee would need to have material evidence of its subordinated relationship with the franchisor and of it being part of the same company of the franchisor, such as credentials and memoranda.

To reduce the risk of a franchisor being considered an employer of its franchisee under Mexican law, it is suggested that the franchisor should require its prospective franchisee to create a Mexican company to enter into the franchise agreement, which in no way limits the right of the franchisor to request the individual with whom it has been dealing to also sign a franchise agreement as personal guarantor.

Likewise, the franchise agreement must contain a provision called 'absence of labour relations and non-representation', in which both parties state that they enter into the franchise agreement in their capacity as independent contractors and establish the distinction and

independence between franchisor, franchisee and the franchisee's employees, among other stipulations.

In general terms, the franchise agreement must be reviewed to confirm that none of its language could be construed as creating labour relations between a franchisor and its franchisee or the employees of the franchisee. Additional practical recommendations may be made on a case-by-case basis.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

Trademarks in Mexico are protected through their registration at the Mexican Institute of Industrial Property (IMPI). Any holder of a trademark registration must prove use of the same, otherwise a cancellation action may be exercised by any third party claiming lack of use by the holder. The Federal Law for the Protection of Industrial Property (IPL) allows for proving the use of a trademark through a licensee (franchisee) provided that the corresponding licence is recorded in the IMPI. In those cases where the franchisor or licensor is not the owner of the trademarks to be sub-licensed in Mexico, then an intercompany trademark licence agreement (or a summary version thereof) between the owner of the trademarks and the franchisor or licensor in Mexico must be registered with the IMPI.

There is no legal obligation for franchisors or franchisees to register a franchise agreement with the IMPI; however, foreign franchisors should consider making such a registration for the purposes of proving the use of their trademarks and protecting their industrial property rights against third parties for the reason explained above. In order not to reveal confidential information contained in the corresponding franchise agreement to the IMPI and in the respective manuals being a part thereof, it is permissible to submit a summary of the franchise agreement containing only the essential information.

There are two alternatives that could be used jointly or separately to protect know-how in Mexico. One is through copyrights based on the federal Copyright Law and the other is through patents or trade (industrial) secrets based on the IPL. In addition, and to efficiently safeguard franchisors' intellectual property rights, it is always advisable to execute confidentiality agreements with the individuals who will have access to information containing know-how.

Trade secrets are known under Mexican law as 'industrial secrets' and are specifically protected under the IPL. In some cases, disclosure of industrial secrets may be considered a felony. The breach of a confidentiality obligation may result in the payment of damages and losses caused, or of a conventional penalty (liquidated damages) if agreed in the corresponding franchise or confidentiality agreement.

Unauthorised use of intellectual property rights is considered an administrative infringement under the IPL and, therefore, the IMPI is entitled to exercise specific actions against the corresponding infringer. Certain violations of the IPL may be considered felonies.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

There are some restrictions on the acquisition of real estate by foreigners or foreign-owned Mexican entities. As a general rule, a foreign individual or entity may directly own real estate in Mexico but foreigners (including individuals or entities) may not acquire direct ownership of land and water located within the 'restricted zone' that consists of a 50km strip of land inland from Mexican coasts and 100km from the country's borders. Although foreigners may not acquire direct ownership in the restricted zone, they can acquire other rights (similar to ownership rights that allow them to dispose of the real estate, and that are commonly used) over real estate in the following cases:

- wholly foreign-owned Mexican entities may directly acquire property within the 'restricted zone' to perform non-residential activities such as industrial, commercial or tourism activities (these acquisitions must be recorded with the Ministry of Foreign Affairs);
- if the real estate is for residential purposes, foreign individuals or entities and Mexican companies with foreign participation in their corporate capital (up to 100 per cent) may acquire the rights of use and benefit from the real estate through a trust; and
- foreign individuals or entities may take and grant a lease in any real estate and other properties in Mexico without any limitation.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

The Federal Economic Competition Law (FECL) is the legal statute applicable to competition matters. According to the provisions of the FECL, if agreements between economic agents tend to diminish, harm or impede the production, processing, distribution or commercialisation of goods and services, those agreements would be considered monopolistic practices. In this regard, an obligation imposed by a franchisor to a franchisee to sell products at determined prices may be considered as a monopolistic practice depending on the amount of power that the economic agents have in the relevant market. However, to avoid risks derived from such law, it is recommended to include a provision in the franchise agreement specifying that the franchisor should provide a list of suggested prices that do not constitute an obligation, but a recommendation.

Violations of the provisions of the FECL may result in the nullity of the acts or agreements that cause such violations, as well as the imposition of fines and payments of damages and losses.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

Article 245 of the Federal Law for the Protection of Industrial Property (IPL) defines a franchise as follows:

> *A franchise exists whenever, in conjunction with a licence to use a trademark granted in writing, technical knowledge is transmitted or technical assistance is furnished in order to enable the licensee to produce or sell goods or render services in a uniform manner and with the operating, commercial and administrative methods established by the holder of the trademark, with the goal of maintaining the quality, prestige and image of the products or services distinguished by the trademark.*

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

Franchises in Mexico are governed and regulated by the IPL and its regulations. The governmental agency in charge of applying the IPL is the Mexican Institute of Industrial Property (IMPI). In addition, there are other laws that may have an application to franchises depending on the type of activity performed in Mexico, such as the Commercial Code, the Consumer Protection Federal Law, the Economic Competition

Federal Law (the Antitrust Law), the Federal Law for Personal Data Protection Possessed by Private Persons, the General Law of Business Organisations and the Federal Civil Code.

Principal requirements

14 What are the principal requirements governing the offer and sale of franchises under the relevant laws?

The IPL requires that, prior to granting a franchise, the franchisor's information (disclosure document) must be provided to the prospective franchisee at least 30 business days before the execution of the franchise agreement.

Franchise agreements must be in writing and contain the following minimum provisions:

- the geographical zone in which the franchisee shall mainly perform the activities that are the subject matter of the agreement;
- the location, minimum size and investment characteristics of the infrastructure, relating to the premises in which the franchisee shall carry out the activities deriving from the agreement;
- if applicable, the policies of inventories, marketing and advertising, as well as the provisions relating to the merchandise supply and the engagement with suppliers;
- the policies, procedures and terms for any reimbursement, financing and other considerations in charge of the parties;
- the criteria and methods applicable to determining the franchisee's commissions and profit margins;
- the characteristics of the technical and operational training of the franchisee's personnel, as well as the method or manner in which the franchisor shall provide technical assistance to the franchisee;
- the criteria, methods and procedures of supervision, information, evaluation and grading of the performance and quality of the services under the respective responsibility of the franchisor and the franchisee;
- the terms and conditions of any sub-franchise, in the event it is agreed by the parties;
- termination causes under the franchise agreement;
- events under which the parties may review and, if this happens, mutually agree to amend the terms or conditions of the franchise agreement;
- if applicable, provisions regarding the franchisee's obligation to sell its assets to the franchisor or the franchisor's designated representative, upon the termination of the franchise agreement; and
- if applicable, provisions regarding the franchisee's obligation to sell or transfer the shares of its company to the franchisor or to make the franchisor a partner of the company.

The Commercial Code and the Federal Civil Code

Franchise agreements are governed by the IPL and by the general rules of contracts contained in the Commercial Code and the Federal Civil Code. Commercial activities and contracts in Mexico, such as franchise agreements, are regulated by the general principle of contractual liberty, which applies to all provisions and aspects of a franchise agreement not specifically regulated by the IPL.

The Federal Consumer Protection Law

The governmental body in charge of applying this law is the Federal Consumer Protection Agency. In general, this law protects consumers and regulates the activities of providers selling goods and rendering services to the consumers. Its provisions include protection for consumers and restrictions regarding the use of information pertaining to the consumers, information provided and advertisements, promotions and offers, services, credit transactions, real estate transactions, warranties, and adhesion contracts, among others.

The Federal Economic Competition Law

The governmental body in charge of applying this law is the Federal Economic Competition Commission. In accordance with the provisions of this law, there are some restrictions on the general principles of contractual freedom, such as when, through agreements, arrangements or a combination of acts between economic agents, the production, processes, distribution or commercialisation of goods and services is diminished, harmed or impeded, in which case the situations are considered monopolistic practices. Infringements of the provisions of the Federal Economic Competition Law may result in the nullity of the acts and agreements in violation of the law and the imposition of administrative fines or the payment of damages and losses to third parties.

The Federal Law for Personal Data Protection Possessed by Private Persons

The government body in charge of applying this law is the National Institute of Transparency, Access to Information and Personal Data Protection. The main purpose of this law is to protect personal data held by private persons in order to regulate the lawful, informed and controlled treatment of said data, with the objective of ensuring the right to privacy as well as the right of control over personal data for persons. The law protects personal data that is subject to treatment, use or transfer at a national and international level.

Franchisor eligibility

15 Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

In terms of the IPL and its regulations, the only requirement that must be met before a franchisor may offer a franchise is the submission of the disclosure document. The IPL states that disclosure must be provided to the prospective franchisee or master franchisee at least 30 days before entering into the corresponding agreement. According to the provisions of the IPL, all terms provided for in that law must be calculated on business days pursuant to the calendar published every year by the IMPI.

The IPL does not provide for any obligation to update the information contained in the disclosure document, which must be accurate at the time it is delivered to the prospective franchisee.

In accordance with the provisions of the regulations of the IPL, the following technical, economic and financial information must be provided through the submission of the disclosure document:

- the name, corporate name or business name, domicile and nationality of the franchisor;
- description of the franchise;
- the seniority of the original main franchisor and, if applicable, of the master franchisee of the business subject matter of the franchise;
- any intellectual property rights involved in the franchise;
- the amounts and concepts of payments that the franchisee must make to the franchisor;
- the types of technical assistance and services that the franchisor must provide to the franchisee;
- a definition of the geographical area in which the business exploiting the franchise operates;
- the rights or restrictions to grant sub-franchises to third parties and, if applicable, the requisites the franchisee must fulfil to grant sub-franchises;
- the obligations of the franchisee with respect to the confidential information provided by the franchisor; and
- in general, the obligations and rights of the franchisee arising from the execution of the franchise agreement.

Franchisee and supplier selection

16 Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

No, there are no restrictions as to the manner in which a franchisor may recruit franchisees or select its own or its franchisees' suppliers.

Pre-contractual disclosure – procedures and formalities

17 What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

The IPL states that disclosure must be provided to the prospective franchisee or master franchisee at least 30 days before entering into the corresponding agreement. According to the provisions of the IPL, all terms provided for in that law must be calculated on business days pursuant to the calendar published every year by the IMPI.

The IPL does not provide for any obligation to update the information contained in the disclosure document, which must be accurate at the time it is delivered to the prospective franchisee.

Pre-contractual disclosure – content

18 What information is the disclosure document required or advised to contain?

According to the regulations of the IPL, the disclosure document must contain the following technical, financial and economic information regarding the franchisor:

- the name, corporate name or business name, domicile and nationality of the franchisor;
- description of the franchise;
- the seniority of the original main franchisor and, if applicable, of the master franchisee of the business subject matter of the franchise;
- any intellectual property rights involved in the franchise;
- the amounts and concepts of payments that the franchisee must make to the franchisor;
- the types of technical assistance and services that the franchisor must provide to the franchisee;
- a definition of the geographical area in which the business exploiting the franchise operates;
- the rights or restrictions to grant sub-franchises to third parties and, if applicable, the requisites the franchisee must fulfil to grant sub-franchises;
- the obligations of the franchisee with respect to the confidential information provided by the franchisor; and
- in general, the obligations and rights of the franchisee arising from the execution of the franchise agreement.

There is no obligation for a franchisor to provide its financial information or to make financial performance representations.

Pre-sale disclosure to sub-franchisees

19 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

The IPL makes no distinction in its applicability to master, individual or unit franchises. Its provisions and the disclosure obligations apply to all types of franchises to be established in Mexico.

The IPL requires 'the grantor of a franchise' to provide disclosure to a prospective franchisee. This requires any franchisor, including a master franchisee acting as a franchisor, to provide disclosure to the prospective franchisee.

Assuming the master franchisee holds sufficient rights in the franchise to execute a sub-franchise agreement, then the master franchisee would also qualify as the grantor of a franchise and be required to provide disclosure to a prospective sub-franchisee. Even if the franchisor is a party to the sub-franchise agreement, the master franchisee must provide the disclosure since it is the actual grantor of a franchise. In the case of a sub-franchising structure, the disclosure document must contain the same level of information applicable to any franchise, but, in addition, it must describe the relationship between the franchisor and the master franchisee, from which the rights of the master franchisee to grant sub-franchises derives.

Due diligence

20 What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

Aside from the obligation for a franchisor to provide disclosure to a prospective franchisee in accordance with the applicable legal provisions in Mexico, there is no legal obligation for the parties to carry out any due diligence. Notwithstanding the foregoing, it is recommended for both franchisors and franchisees to carry out due diligence prior to entering into a franchise transaction. This due diligence may include market studies on the commercial feasibility of the potential franchised business in the territory, as well as independent investigations on the prospective franchisee, including criminal history, credit condition and liens or encumbrances over the assets of the prospective franchisee or its principal owners. Any potential franchisee must carefully review the legal status of the trademarks that may be licensed under a franchise agreement.

Failure to disclose – enforcement and remedies

21 What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

The only individual or entity liable for a breach of the disclosure obligation is the individual or entity that will effectively grant the franchise. There is no extended liability of the officers, directors or employees of the franchisor for violation of this legal obligation.

Failure to disclose – apportionment of liability

22 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

The IPL makes no distinction in its applicability to franchisors or master franchises as sub-franchisors. It is simply required for the 'grantor of a franchise' to provide disclosure to a prospective franchisee, which includes a master franchisee acting as sub-franchisor. Even if the franchisor is a party to the sub-franchise agreement, it is the master franchisee who must provide the disclosure since it is the one granting the franchise. In such a case, the disclosure document must contain the same level of information applicable to any franchise and include a description of the relationship between the franchisor and the master franchisee.

Individual officers, directors and employees of the franchisor or the sub-franchisor are not exposed to personal liability for the breach by the franchisor or the sub-franchisor to the disclosure obligation.

General legal principles and codes of conduct

23 | In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

The only laws that govern the offering and selling of franchises are the IPL, the Regulations of the IPL, the Commercial Code and the Federal Civil Code. Franchise transactions are ruled by the general principle of contractual liberty, provided that the terms and conditions contemplated by or contained in the relevant agreements are not against these laws. If the franchisee is able to prove that his or her consent to enter into a franchise agreement was granted based on an error the franchisee made owing to violence or bad faith on the part of the franchisor, then the franchisee may be entitled to exercise a legal action and claim for the nullity of the agreement.

Fraudulent sale

24 | What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

Depending on the specific fraudulent conduct of the franchisor, the franchisee may request the nullity of the franchise agreement, the payment of damages and losses and, in some particular cases, criminal prosecution for fraud.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 | What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The Commercial Code, the Federal Civil Code and the general principles applicable to contracts and of contractual liberty are the laws and principles applicable to the ongoing relationship between the franchisor and franchisee; therefore, such a relation will be mainly governed by the terms and conditions of the franchise agreement.

Operational compliance

26 | What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

It is a common practice to include in franchise agreements the right of franchisors to carry out inspection visits to the premises of the franchisee, as well as to audit the books and records of the franchisee. The foregoing is to determine if the franchised business is in compliance with the minimum operational and quality standards imposed by the franchisor and the relevant system, and to verify that payments made by franchisees are being correctly calculated pursuant to the provisions of the franchise agreement. Depending on the volume and structure of operations of the franchisor, it may also be common for franchisors to hire the services of a local third party to take care of some of such tasks on its behalf, in which case this alternative would need to be addressed in the corresponding agreement.

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

It is possible for the franchisor to unilaterally modify the operational terms and standards of the franchise system, provided that this right is expressly contemplated in the agreement and that the franchisor assumes the obligation to notify the franchisee with certain anticipation, in order for the franchisee to have enough time to implement the applicable changes. In our opinion, if the implementation of these changes is likely to mean a very high cost for the franchisee, we consider that the franchisee must have the right to terminate the franchise agreement without any liability for both parties.

Policy affecting franchise relations

28 | Do other government or trade association policies affect the franchise relationship?

No other government or trade association policies affect the franchise relationship.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

If there are no specific circumstances detailed in the franchise agreement for the anticipated termination or rescission of that agreement, then the provisions of the Federal Civil Code apply. These establish that if a party to a contract is in breach of its obligations derived from the corresponding agreement and the other party is in compliance with its own contractual obligations, the non-defaulting party shall have the right to request from the courts having jurisdiction over the matter the rescission of the contract based on the breach by the defaulting party, as well as the payment of corresponding damages and losses.

In addition, if, as a result of an event that is not attributable to any of the parties (that is, due to force majeure or acts of God), the performance of the obligations derived from the agreement is deemed to be impossible, any of the parties may request from the corresponding judicial authority a declaration of termination of the agreement without fault on any side.

Finally, if the agreement is executed for an undetermined period of time, any of the parties have the right to terminate the agreement at any time, though prior notice must be given to the other party. Although there is no specific term for the anticipation of the delivery of the termination notice, the custom in Mexico is to deliver the notice at least 30 calendar days before the effective date of termination.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

In addition to the specific circumstances provided by the Federal Law for the Protection of Industrial Property (IPL) that basically refer to the lack of veracity of the information disclosed, a franchisee may terminate a franchise agreement in the same circumstances applicable to a franchisor.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

Renewals of franchise agreements are usually effected through either the execution of an amendment to the existing franchise agreement,

especially to its duration and any other applicable provisions that would need to be modified, in which case no disclosure obligation would be triggered, or by means of executing a new franchise agreement, under the terms of the form of agreement used at that time by the franchisor. This second alternative would definitely have, as a direct consequence, the obligation for the franchisor to comply with its disclosure obligation under Mexican law. There are no specific formalities or other requirements that would apply to either of those two possibilities.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

If there are no renewal provisions or rights detailed by the franchise agreement, upon expiration of the duration of the agreement the franchisor may freely refuse to renew the agreement.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Pursuant to the provisions of the Federal Civil Code, a franchisee would not be authorised to assign its obligations derived from a franchise agreement without the previous consent of the franchisor. The parties may regulate the transfer of rights and obligations in the franchise agreement with the understanding that they may agree on restrictions for the franchisee to assign or transfer its rights and obligations in the franchise agreement and to subject such transfer to the prior written authorisation of the franchisor, which may be granted or denied at its sole discretion.

With respect to the transfer of ownership interests in the entity appointed as franchisee, the franchisor shall only have the right to restrict such a transfer if, as a consequence, it may modify the personal characteristics of the franchisee that were foreseen by the franchisor as the main motive for entering into the franchise agreement. Therefore, it is advisable to reflect in the franchise agreement that the franchisee must obtain the prior written authorisation of the franchisor for such a transfer.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

There are no laws or regulations affecting the nature, amount or payment of fees. All the same, depending on the nature of the goods or services for which payment is being made, the tax treatment may have different implications. Normally, the international tax treaties to which Mexico is a party distinguish different concepts of payment such as royalties, technical assistance and business profits that have different withholding rates. Therefore, specific tax analysis of the concepts of payment that may derive from a franchise agreement is strongly recommended before entering into the agreement.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

The franchise agreement is a contract of commercial or mercantile nature, regulated by mercantile laws such as the Commercial Code. As a consequence, according to the provisions of the Commercial Code, there are no restrictions on the amount or percentage of interest that may be charged by a franchisor to a franchisee on overdue payments, even if the franchisee is a natural person or a civil partnership.

If the parties fail to include the applicable default interest on overdue payments in the franchise agreement, then the franchisor will be entitled to charge the legal interest of 6 per cent per annum set forth in the Commercial Code.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

Parties to a franchise agreement can agree in the corresponding contract or agreement to make payments in any currency. But if according to the corresponding contract or agreement the payment is to be made within the territory of Mexico, then, pursuant to the provisions of the Monetary Law, the party obligated to make the corresponding payment may freely elect to make such a payment either in the foreign currency agreed in the contract or agreement or in Mexican currency (pesos) according to the exchange rate published by Mexico's Central Bank in the Official Gazette on the date of payment. If it is agreed that payments are to be made abroad, then the party obliged to make such a payment cannot elect to make it in Mexican currency based on the provisions of the Monetary Law.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants can be enforced in Mexico, especially if violation of the confidentiality obligation under the agreement is sanctioned through the payment of a conventional penalty (a figure similar to liquidated damages) and if the contractual breach constitutes a violation of the IPL. Pursuant to the provisions of the IPL, violation of a confidentiality obligation through the non-authorised disclosure of a trade (industrial) secret may be considered a felony and can be criminally prosecuted.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

In accordance with the provisions of the Federal Civil Code, the consent of a party to an agreement will not be valid if that party was in 'error' when granting its consent. A legal or factual error nullifies the agreement when such an error exists with respect to the mistaken party's main motive for entering into the franchise agreement. In this regard, the Federal Civil Code describes 'bad faith' as the dissimulation of an error by a party to an agreement that was known by the said party. As a consequence, and interpreting the above-mentioned provisions of law in a contrary sense, the parties to an agreement such as a franchise agreement must deal with each other in good faith, not only when executing the agreement, but also during the term thereof.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

In principle, under the Federal Consumer Protection Law a 'consumer' is considered to be the natural person or entity that acquires or enjoys goods, products or services as the final beneficiary of the same, and a 'supplier' is considered to be the natural person or entity that regularly offers, distributes, sells, leases or grants the use of goods, products, services or a combination of these. In terms of Mexican legislation, a franchisee is normally considered to be a supplier and not a consumer. An exception to the above is that when a transaction between

a franchisee and a third-party supplier (such as the franchisor) involves a claim equal to or less than 367,119.59 pesos, a franchisee could be considered a consumer under the Federal Consumer Protection Law and, therefore, the franchisee may benefit from the protection provided by such statute. In this regard, if the franchisee is an entity, it shall only be considered as a consumer if, in addition to complying with the aforementioned condition, the franchisee is considered to be a micro-entity or a micro-industry in terms of the Law for the Development of Competitiveness of Micro, Small and Medium Entities and the Federal Law for the Promotion of the Micro-Industry and Handicraft Activity.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

The IPL does not impose any obligations for the disclosure documents and franchise agreements to be prepared in Spanish; however, the summary of the franchise agreement that should be recorded with the Mexican Institute of Industrial Property (IMPI) must be in Spanish.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

Franchise agreements must be executed in writing and comply with the minimum requirements indicated below:

- the geographical zone in which the franchisee shall mainly perform the activities that are the subject matter of the agreement;
- the location, minimum size and investment characteristics of the infrastructure, relating to the premises in which the franchisee shall carry out the activities deriving from the agreement;
- if applicable, the policies of inventories, marketing and advertising, as well as the provisions relating to the merchandise supply and the engagement with suppliers;
- the policies, procedures and terms for any reimbursement, financing and other considerations in charge of the parties;
- the criteria and methods applicable to determining the franchisee's commissions and profit margins;
- the characteristics of the technical and operational training of the franchisee's personnel, as well as the method or manner in which the franchisor shall provide technical assistance to the franchisee;
- the criteria, methods and procedures of supervision, information, evaluation and grading of the performance and quality of the services under the respective responsibility of the franchisor and the franchisee;
- the terms and conditions of any sub-franchise, in the event it is agreed by the parties;
- termination causes under the franchise agreement;
- events under which the parties may review and, if this happens, mutually agree to amend the terms or conditions of the franchise agreement;
- if applicable, provisions regarding the franchisee's obligation to sell its assets to the franchisor or the franchisor's designated representative, upon the termination of the franchise agreement; and
- if applicable, provisions regarding the franchisee's obligation to sell or transfer the shares of its company to the franchisor or to make the franchisor a partner of the company.

Likewise, none of the parties to a franchise agreement are entitled to terminate or rescind the agreement unless it is entered into for an undetermined period of time, or in the event of a just cause that can be foreseen in the agreement.

According to the contractual freedom principle provided by Mexican civil and commercial laws, the parties to a franchise agreement (it being an agreement of a commercial nature) are allowed to include any type of restrictions, covenants and obligations applicable to the relationship between the parties, provided that the restrictions, covenants and obligations are not against any specific legal limitation or public order. It is a common practice for franchisors to include in franchise agreements territorial restrictions for the franchisee to operate the franchised business; the obligation for the franchisee to acquire goods or services only from the franchisor or from those sources or suppliers expressly authorised by the franchisor; the ranges of prices under which the franchisee must offer goods or services to the public, as well as other terms and conditions normally contained in commercial agreements, such as governing laws and mechanism for dispute resolution. Non-compete obligations and those restrictions for non-solicitation of employees of the franchisor or other franchisees must be carefully reviewed, since they could be against constitutional principles and, consequently, null and void.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

If a dispute arises under a franchise agreement that is considered as a commercial or mercantile agreement, and if the parties to it decide to submit themselves to the applicable laws and competent courts, an ordinary commercial or mercantile procedure may be initiated. The final resolution issued by the corresponding local judge in the first instance may be appealed before the local court of appeals. The final resolution issued by the court of appeals in the second instance may be challenged before a federal court through a constitutional procedure, also known as *amparo*, but only if during the process specific constitutional rights were violated or if the final resolution is issued against the principles of Mexico's Constitution. The resolution issued by the court in an *amparo* procedure is final and definitive.

An alternative dispute resolution mechanism is arbitration, which may be subject to Mexican or foreign law. Awards that are issued under the law of a country that is party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards are recognised and enforced in Mexico as long as such awards are not contrary to Mexico's public order laws. Foreign judgments and arbitration awards that do not contravene public order laws are enforced in Mexico through a recognition and enforcement procedure before a judge, by means of a homologation process, given that Mexico is a party to the United Nations Convention.

The dispute resolution alternatives (jurisdictional and arbitration) are in addition to and independent from any administrative infringement action that may be initiated by a franchisor against any person violating the provisions of the IPL, in which case the IMPI is authorised to impose provisional or precautionary measures that include the seizure of merchandise and the closure of premises.

Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

A franchise agreement must comply with the applicable provisions of the law, regardless of the nationality or place of residence of the parties. This is applicable to the sale and offer of franchises to entities or individuals in Mexico.

Notwithstanding the above, the parties to a franchise agreement can freely agree to have Mexican or foreign laws to govern their contractual relationship.

If the agreement is governed by foreign law, it is recommended that any dispute between the parties be submitted to binding arbitration. Mexico is a party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards; therefore, an award issued under the laws of a country that is part of this convention should be enforced in Mexico, with the understanding that it is not against Mexico's public order laws.

If a franchise agreement is governed by Mexican laws, the parties can agree that any dispute under those laws may be solved by binding arbitration or they can agree to submit the dispute to the jurisdiction of the Mexican courts.

Arbitration – advantages for franchisors

44 What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

In general, arbitration may have more advantages than disadvantages, especially when the foreign franchisor does not have a local subsidiary and operations in Mexico. Arbitration has proved to be time-efficient, and if Mexican law is governing the franchise agreement and the resolution of the dispute, it should be possible to enforce an arbitral award. Arbitration in the franchise industry also carries the advantage of allowing the resolution of a problem to be carried out by one or more arbitrators with the necessary expertise and knowledge in franchising, which is a subject not necessarily known or explored by the courts. The most important possible disadvantage is that in certain cases the related costs and fees could be much higher than those applicable in a jurisdictional procedure, depending on the agency administering the arbitration, its rules and the profile of the arbitrators.

National treatment

45 In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

From a legal and practical point of view, domestic and foreign franchisors have equal treatment in Mexico and are equally protected and restricted in terms of Mexican legislation, but lack of knowledge of the domestic laws, administrative restrictions and commercial and operational customs, as well as the lack of legal advice from a competent Mexican law firm, are important elements that could hamper foreign franchisors' entry into the Mexican market.

UPDATE AND TRENDS

Legal and other current developments

46 Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

On 1 July 2020, the federal government published in the Official Gazette of the Federation a new Federal Law for the Protection of Industrial Property, which abrogated the former Industrial Property Law. This new law became effective on 5 November 2020 and is a consequence of the compromises made by the Mexican government along with the governments of the United States and Canada to harmonise certain pieces of legislation through the United States, Mexico and Canada Commercial Agreement, which also entered into effect on 1 July 2020 and substitutes the North American Free Trade Agreement. The new Intellectual Property Law did not modify the provisions applicable to franchising.

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Netherlands

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

There are approximately 870 franchise formulas operating in the Netherlands, with over 34,200 franchise outlets. Franchise businesses employ over 375,000 people and annual sales are well over €55 billion. This makes the franchise sector considerably important to the Dutch economy. Franchising is found in many industries, with focal points in retail (both food and non-food), services (for instance, medical services) and care, and comes in many forms. These vary from soft franchising, where the franchisee has a lot of freedom within the franchise to structure its activities (eg, by making its own selection from a wide range of products available to the franchise), to hard franchising, where the business operations are prescribed by the franchisor down to the smallest detail. In hard franchising, the franchisee is largely unburdened and in exchange, he or she relinquishes some of the freedom of movement in his or her entrepreneurship, as outlined in the explanatory note to the new Dutch Franchise Act, effective as of 1 January 2021.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The Dutch Franchise Association (NFV) represents the interests of its affiliated members (namely, franchise organisations). Its main objective is to promote the healthy and balanced development of franchising in the Netherlands. The NFV is a member of the European Franchise Federation, as are franchise associations in almost all European countries. The NFV is also a member of the World Franchise Council, which is a forum where supranational issues can be discussed.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

Franchises may come in the form of any business entity existing under Dutch law, in particular:

- private limited liability companies (BVs);
- public companies (NVs);
- sole proprietorships;
- general partnerships; and
- limited partnerships.

BVs and NVs are legal entities. General partnerships, limited partnerships and sole proprietorships are non-legal entities. The question of whether a business entity is a legal entity or not affects the franchisor's personal liability.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

The formation of business entities is governed by Book 2 of the Dutch Civil Code for legal entities and Book 7A of the Dutch Civil Code. There are also several specific relevant laws for business entities, for example, the Works Councils Act. All business entities must be duly registered in the Commercial Register of the Dutch Chamber of Commerce.

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

The requirements for forming and maintaining a business entity depend on what form of business entity is incorporated. When a private limited liability is used by the franchisor, the following are required:

- a statement of no objection from the Dutch Ministry of Justice; and
- a notarial deed of incorporation, including the articles of association.

On 1 October 2012, an act for the simplification of private company law entered into force, making important changes to Dutch law applicable to BVs. From this date, the laws with respect to BVs became simpler and more flexible. As a result, it is now possible to deviate more from the statutory rules in the articles of association of the company and a minimum capital of €18,000 is no longer necessary. Furthermore, the mandatory bank and accountants' statements with a contribution in kind have been abolished. A notarial deed of incorporation is still required. The act entered into force with immediate effect and is applicable to all BVs. The act introduced several possibilities to deviate from the provisions of the law in the articles of association, which offered foreign investors more freedom to incorporate or structure their BV as they deem appropriate.

Restrictions on foreign investors

6 What restrictions apply to foreign business entities and foreign investment?

Business entities that are incorporated under foreign law but are active on the Dutch market rather than within their own country are subject

to the Companies Formally Registered Abroad Act (CFRA Act). The CFRA Act does not apply to members of the European Union or to countries that are members of the European Economic Area Agreement. All other entities must comply with certain requirements, which also apply to Dutch entities (such as registration in the Commercial Register, statutory minimum capital and the filing of annual accounts with the Commercial Register where the business entity is registered).

Taxation

7 What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

In principle, taxable profits realised by corporate entities that are for tax purposes resident in the Netherlands – for example, Dutch limited liability companies (BVs and NVs) – are subject to the Dutch corporate income tax rate. Dividends received and capital gains derived from a shareholding to which the Dutch participation exemption applies are exempt from Dutch corporate income tax. Dividends distributed by a Dutch tax-resident company are generally subject to Dutch dividend withholding tax. A reduced rate or an exemption from Dutch dividend withholding tax may be available; for example, as a result of the application of a tax treaty or if the Dutch participation exemption applies. In principle, dividends distributed to an EU shareholder holding more than 5 per cent are also exempt from Dutch dividend withholding tax. In general, Dutch corporate taxpayers can credit dividend tax withheld against corporate income tax due.

Individual shareholders holding more than 5 per cent in the nominal share capital of a company (substantial interest) are generally subject to Dutch individual income tax in respect of dividends received and capital gains derived from such substantial interest. Individual shareholders holding less than 5 per cent in the nominal share capital of a company are generally subject to Dutch individual income tax.

Individuals performing franchise activities in the Netherlands, either in the form of tax transparent partnerships or as sole entrepreneurs, are generally subject to income tax at progressive rates. Dutch individual entrepreneurs may apply a number of beneficial tax facilities.

No taxes are levied upon establishing a business in the Netherlands. Dutch capital tax, which was due on the incorporation of a company with capital divided into shares, was abolished as of 1 January 2006. The acquisition of Dutch houses is currently subject to real estate transfer tax. For real estate business premises, a Dutch real estate transfer tax applies. In certain circumstances, the acquisition of more than 33.33 per cent of a Dutch real estate company is also subject to Dutch real estate transfer tax.

Wages paid by a Dutch employer are subject to Dutch wage withholding tax and Dutch social security premiums. Dutch wage withholding tax is creditable against the Dutch individual income tax liability in full. Attractive tax benefits are available for foreign employees if these employees have certain specific skills that are scarce in the Netherlands.

Dutch value added tax (VAT) currently amounts to 21 per cent. Reduced VAT rates of 6 per cent and zero per cent apply for certain supplies, such as the supply of agricultural products. Imports performed by Dutch entrepreneurs are generally subject to Dutch VAT. In principle, the importing entrepreneur may credit or refund the VAT paid on the imported supplies. Exports from the Netherlands are generally exempt from Dutch VAT.

Labour and employment

8 Are there any relevant labour and employment considerations for typical franchisors?

In principle, franchisees are deemed independent entrepreneurs. Hence, no labour and employment considerations apply. However, franchisees may qualify as employees on the basis that the relationship between the franchisor and franchisee does not correspond with the franchise agreement as it is in fact an employment relationship. Case law shows that this is often the case with self-employed persons such as driving instructors and door-to-door salespeople. If the agreement is considered an employment agreement, the franchisee is, inter alia, entitled to holiday allowance and payment during illness. Also, laws regarding termination of the employment agreement apply.

According to tax law, the franchisor is required to withhold income tax and social security benefits in case the tax authorities deem the relationship between parties a (fictitious) employment relationship. Each cooperation agreement, such as a franchise agreement, is considered on its own merits. The name and wording of the contract between the parties is not decisive. The courts look at the intention of the parties when entering into the franchise contract, as well as the way in which the parties have given substance to their relationship. If it is established that the franchisee is obliged to perform the agreed duties in person, that the franchisor pays the franchisee (directly or indirectly) for these duties and that a relationship of authority can be established that manifests itself in the right of the franchisor to give instructions that the franchisee must follow, an employment relationship can be assumed. Particularly in franchise relationships, the following criteria prove to be decisive: equivalence of the contracting parties, the ability of the franchisee to let someone else perform the duties (for example, third parties or employees of the franchisee), the franchisee bearing the business risk and economic independence of the franchisee. Provided that the franchisee is truly a franchisee, pursuant not only to the contract but also to its day-to-day activities, no employment relationship should be deemed to exist. Particularly if the franchisee is contracted via his or her Dutch limited liability company, the risk of an employment relationship is limited, at least from a civil law perspective. The tax authorities have a different view on this.

Intellectual property

9 How are trademarks and other intellectual property and know-how protected?

Registered trademarks are protected by the Benelux Treaty for Intellectual Property. The registrant of a Benelux trademark has exclusive rights for specific classes of goods or services in Belgium, the Netherlands and Luxembourg if a trademark is registered in the public trademark registry of the Benelux Office for Intellectual Property. In addition, the registrant has exclusive rights for specific classes of goods or services in the European Union if a trademark is registered as a community trademark in the public trademark registry of the Office for Harmonisation of the Internal Market of the European Union.

In principle, know-how is not protected by any intellectual property right. However, know-how may be protected under the general provisions of Dutch unfair competition law (including civil tort). Know-how could be contractually protected by including confidentiality (non-disclosure) obligations in an agreement (eg, a franchise agreement).

Real estate

10 What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

In the Netherlands, there are no restrictions on the acquisition of real estate by foreigners. Therefore, foreign franchisors would not face difficulties should they wish to purchase real estate to lease to franchisees. However, franchisors must take the protection of lessees under the semi-mandatory Dutch lease law into account, even if the properties have been made available to the franchisees in the franchise agreement and no specific lease agreement has been drawn up.

There are two different tenancy regimes for the lease of commercial premises: the lease of retail space (including shops, restaurants and takeaways) and the lease of the other commercial premises (including travel agencies, cinemas, the ticket offices of lotteries and bank branches). Under the retail space regime, lessees are protected by various conditions of semi-mandatory lease law, including but not limited to:

- a minimum lease term of two to five years and limited grounds for termination by the lessor;
- termination or rescission can in principle only be effectuated judicially (also in the event of breach of contract); and
- the turnover rent may be affected by market rent review.

Under the regime of other commercial premises, the lessees only get protection of vacation. The lessees are entitled (within two months of the date of vacation) to request the court to extend the term of vacation. The court can be requested to approve a deviation from semi-mandatory law.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

Franchising agreements that do not meet the criteria set forth in Regulation (EU) No. 330/2010, and to which no de minimis thresholds apply, will be prohibited on the basis of article 6.1 of the Dutch Competition Act (DCA) or article 10 of the Treaty on the Functioning of the European Union (TFEU), unless the four criteria detailing the legal exception of article 6.3 of the DCA or article 101(3) TFEU apply. Competition laws in the Netherlands are enforced both administratively and by means of civil litigation (private enforcement). The Dutch Competition Authority can impose fines if a franchising agreement disregards what is set forth in Regulation (EU) No. 330/2010, in particular if the agreement contains any hardcore restrictions (eg, resale price maintenance). The maximum statutory fine is 10 per cent of the undertaking's worldwide turnover. A party to a franchising agreement claiming that the agreement infringes article 6.1 of the DCA or 101(1) TFEU can invoke the nullity of the agreement (in whole or in part) before a Dutch court. The court must then decide on the applicability of Regulation (EU) No. 330/2010 or the legal exception of article 6.1 of the DCA or article 101(1) TFEU. If it decides in the affirmative, it must subsequently determine whether this leads to nullity of only the infringing clauses or nullity of the agreement in its entirety. The latter will be the case if the court determines that without the infringing clause, the agreement would not (or would not on similar terms) have been concluded. In a few instances, the court has nullified a franchising agreement in its entirety, notably because the franchisor engaged in resale price maintenance.

The Authority for Consumers and the Market (ACM) supervises whether franchise and distribution agreements are disadvantageous to competition and consumers in the Netherlands, in which case the agreements may be prohibited. On 26 February 2019, the ACM published new guidelines for agreements between suppliers and buyers. Around this time, the ACM announced that, in future, it will be more vigilant regarding prohibited price agreements. This also seems to match the new line of the European Commission, which, until recently, did not prioritise this subject either.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

In the new Franchise Act, effective from 1 January 2021, the term 'franchise' has not been explicitly defined, but both 'franchise agreement' and 'franchise formula' are defined terms.

A franchise agreement is defined as follows in article 911 (1) of the Franchise Act:

> *an agreement pursuant to which the franchisor grants a franchisee, in return for a fee, the right and the obligation to operate a franchise formula, in the manner indicated by the franchisor, for the production or sale of goods or the provision of services.*

A franchise formula is defined as follows in article 911 (2) of the Franchise Act:

> *an operational, commercial, and organizational formula for the production or sale of goods or the provision of services that is decisive for a uniform identity and image of the franchise enterprises within the chain where this formula is applied, and that in any case comprises:*
>
> *i a trademark, model or trade name, house style or design; and*
>
> *ii know-how: i.e. an entirety of practical information not protected by intellectual property rights, derived from franchisor's experience and from the investigations it has carried out, which information is secret, substantial, and identified[.]*

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

There were numerous discussions about the need for a franchise law or franchise code in the Netherlands. At the beginning of 2015, the Ministry of Economic Affairs appointed a committee to prepare the Dutch Franchise Code, which was finalised in February 2016. The intention of the Ministry was that franchisors and franchisees in the Netherlands could voluntarily follow this code. However, a large majority of the franchisors were opposed to and rejected the Franchise Code, refusing to apply it to their franchise contracts.

At the end of 2016, the Ministry proposed a draft franchise bill that would declare the Franchise Code mandatory law. This draft franchise bill was rejected by many stakeholders during the consultation phase. The newly installed Dutch government indicated, in October 2017, that it wanted to introduce new legislation in the field of franchising to enforce the position of franchisees in the pre-competitive phase. On 12 December 2018, Mona Keijzer, the Under-Secretary of Economic Affairs and Climate, presented a new draft bill on franchises to the franchise sector for consultation. It has become an independent act that does not relate any more to the widely criticised Franchise Code. This new Franchise Act was adopted by the Dutch parliament and senate in mid-2020 and came into force on 1 January 2021.

Principal requirements

14 | What are the principal requirements governing the offer and sale of franchises under the relevant laws?

The Netherlands has moved from a country where franchising was not regulated to one of the most highly regulated countries in the world.

Of all the requirements under the new Franchise Act, seeking consent from the majority of the franchisees to innovate and change the franchise formula but also to start with a derived formula may become the greatest challenge for franchise formulas. According to article 911 (2) of the Franchise Act, a derived formula is an operational, commercial and organisational formula that:

1 is decisive for a uniform identity and image of the enterprises in which this formula is applied;
2 corresponds to a franchise formula in one or more distinctive features that are recognisable to the public; and
3 is used directly or through third parties by a franchisor for the production or sale of goods, or the provision of services that are wholly or largely the same as the goods or services covered by the franchise formula within the meaning mentioned in (2).

A consequence of a derived formula could be that it competes with a franchisee's business operation.

Regarding the maintenance of the franchise relationship between franchisor and franchisee, the general obligation for them to behave 'as a good franchisor and a good franchisee' toward each other is stipulated in the Franchise Act. Furthermore, the provision of assistance and commercial and technical support by the franchisor to the franchisee is one of the core elements of a franchise relationship.

Other principal requirements are:

- providing prospective franchisees with financial information, either historically if available for the franchisee's location or for similar locations, wherein the franchisor must explain why it has decided that the locations are similar and where it may deviate (this could lead to prognosis claims later on when results at the franchisee's location are lower than projected);
- sharing financial information with franchisees during the co-operation, including how the fees contributed by the franchisees are being spent and arguably also kick-backs or bonuses provided by suppliers, but guidelines on this are not currently explicit;
- agreeing on a goodwill calculation in the franchise agreement; and
- complying with non-compete restrictions.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

There are no specific requirements that must be met before a franchisor may offer franchises.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

Good franchising practice suggests that the franchisor should employ a careful process for recruiting and selecting franchisees, as the franchisor and its other franchisees may be negatively impacted by the improper operation of that franchise formula by an incompetent franchisee. This can damage the image and strength of the franchise chain and is therefore not compatible with good franchising practice.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

A franchisor has far-reaching disclosure obligations in the pre-contractual phase towards the prospective franchisee. This includes any information that is or could reasonably be relevant and this information should enable the franchisee to make a well-considered decision to enter into a franchise agreement. The franchisee provides the franchisor with timely information about its financial position, insofar as it is reasonably relevant to enter into the franchise agreement. According to the explanatory memorandum accompanying the Franchise Act, the information should be clear, comprehensible, unambiguously formulated and tailored to the average franchisee. As an example, the explanatory memorandum suggests the addition of an explanatory note in the franchise agreement that explains the most important rights and obligations in the franchise agreement and their impact. This information should be provided at least four weeks prior to entering into the franchise agreement. During this standstill period, it is not possible to amend the draft franchise agreement, unless such amendment is to the benefit of the prospective franchisee. It is also not possible for the franchisor to request investments or other payments from the franchisee in view of the upcoming franchise relationship. The standstill period enables the prospective franchisee to fulfil its duty of investigation, to assess all the documents, to engage an expert, and to come to further questions or obtain further consultation about the content and the implementation of the franchise agreement. Since the franchise disclosure document contains the franchisor's confidential information, the prospective franchisee can be obliged to sign a non-disclosure agreement before receiving the franchise disclosure document.

Pre-contractual disclosure – content

18 | What information is the disclosure document required or advised to contain?

The prospective franchisee must provide the franchisor with timely information about his or her financial position if it is reasonably relevant to enter into the franchise agreement. Furthermore, the franchisor must provide the prospective franchisee, in a timely manner, with:

- the draft of the franchise agreement, including its appendices;
- a statement of the content and scope of rules regarding fees, surcharges, or other financial contributions to be paid by the franchisee or regarding the investments required from the franchisee; and
- information about:
  - the manner and frequency of any consultation between the franchisor and the franchisees and, if available, the contact details of the body representing the franchisees;
  - the extent to and the manner in which the franchisor can enter into competition with the franchisee, including whether this may be by means of a derived formula; and
  - the extent to, the frequency with and the manner in which the franchisee will have access to turnover-related data relating to the franchisee or relevant to the franchisee's business operations.

In addition, the franchisor must provide the prospective franchisee with the following information (if available to the franchisor, to a subsidiary or to a group company affiliated with the franchisor) in a timely manner if it is reasonably relevant to the conclusion of the franchise agreement:

- information about the franchisor's financial position; and

- financial data regarding the intended location of the franchise enterprise or, if such information is not available, financial data of one or more enterprises considered by the franchisor to be comparable, along with information from the franchisor making it clear the reasons why he or she considers them to be comparable.

Furthermore, the franchisor must provide the prospective franchisee with all other information that he or she knows, or can reasonably assume, to be relevant for the conclusion of the franchise agreement.

Pre-sale disclosure to sub-franchisees

19 | In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

In the Franchise Act and its explanatory memorandum, the situation of sub-franchising and the rights and obligations of the involved parties are not mentioned. Also, as there is currently no case law available on this subject, it is unclear how courts will address sub-franchising. However, it seems to be most logical that the party who concludes the franchise agreement with the sub-franchisees will be the party obliged to fulfil all disclosure requirements. This will generally be the sub-franchisor.

Due diligence

20 | What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

Good franchising practice suggests that the franchisor must employ a careful process for recruiting and selecting franchisees. After all, the franchisor and other franchisees operating the franchise formula in question may be negatively impacted by improper operation of that franchise formula by an incompetent franchisee. This can damage the image and strength of the franchise chain and is therefore not compatible with good franchising practice.

Incidentally, the provision of information is not a one-way street. The prospective franchisee has an obligation to provide the franchisor with timely information about its financial position 'to the extent reasonably relevant to the conclusion of the franchise agreement', as stipulated in article 913 (3) of the Franchise Act. The franchisee also has a special duty of investigation. The franchisee is obliged, within the limits of reasonableness and fairness, to take necessary measures to avoid entering into a franchise agreement under the influence of incorrect assumptions. This is intended to prevent the franchisee from relying solely on communications from the franchisor. In doing so, the franchisee may be expected to maintain a critical attitude. In certain circumstances, this may involve the franchisee seeking external advice from trade associations or other experts.

Failure to disclose – enforcement and remedies

21 | What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

The Franchise Act is mandatory law. Deviating from the main provisions in a franchise agreement to the disadvantage of a franchisee operating in the Netherlands is not permitted. Such deviating clauses are invalid. If the franchise agreement contains deviating clauses, they cannot be invoked. When the franchisor does not provide the franchisee with the required information, either before the conclusion of the franchise agreement or thereafter, this could render the franchisor liable for any decisions that the franchisee makes without knowledge of such information when afterwards the franchisee claims that, with the required information, it would have decided otherwise or maybe would not even have concluded the franchise agreement. Consequently, the franchise agreement itself could be annulled and the franchisor may be compelled to compensate the franchisee for all fees paid, investments and costs made in the execution of the franchise agreement. The franchisee usually has three years to nullify all or part of the franchise agreement, which would require undoing the services rendered back and forth (including all payments, investments and costs made).

Another risk arises when a franchisor does not request the consent of its franchisees for certain changes (for instance, changes to the franchise formula, required investments, additional costs, or changes that may impact the revenue of the franchisees or the development and implementation of a derived formula) and the franchisees are of the opinion that those changes will have a negative financial impact. In these cases, the franchisees (either individually or with other franchisees) may claim damages or costs as a result of the decision made by the franchisor. The franchisees may also try to stop the franchisor from implementing new elements, decisions or a derived formula by requesting court intervention, for example a preliminary injunction, with the argumentation that the franchisees had not given their consent for these changes. The court could rule that the franchisor is not at liberty to implement certain changes and could be subject to penalties.

Failure to disclose – apportionment of liability

22 | In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

In the Franchise Act and its explanatory memorandum, the situation of sub-franchising and the rights and obligations of the involved parties are not mentioned. Also, as there is currently no case law available on this subject, it is unclear how courts will address sub-franchising. However, it seems to be most logical that the party who concludes the franchise agreement with the sub-franchisees will be the party obliged to fulfil all disclosure requirements. This will generally be the sub-franchisor.

Under Dutch law, private companies with limited liability and public companies limited by shares both have legal personality. In principle, therefore, liability rests with the business and not with individual officers, directors or employees. Individual officers or directors are only exposed to liability in the event of improper management on their part that amounts to personal culpability of the directors. The burden of proof rests on the franchisee.

General legal principles and codes of conduct

23 | In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

General civil law principles

In addition to the Franchise Act, the general laws of contract apply as well as Dutch court decisions. Book 6 of the Dutch Civil Code sets out the requirements relating to the formation of contracts. These provisions must be read in conjunction with the more general rules regarding

juridical acts; that is, acts intended to invoke legal consequences provided in Book 3 of the Dutch Civil Code. In the legal literature and jurisprudence, certain rules of law in relation to franchises have been developed. It is important to be aware that all contracts concluded under Dutch law are subject to the general requirements of reasonableness and fairness.

EU and Dutch competition laws

Besides the civil law aspects, in franchising (as well as distribution and all other vertical agreements) competition laws play an important role. The European Commission Guidelines to Commission Regulation (EU) No. 330/2010 of 20 April 2010 on the applicability of article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices is very important, as well as the guidelines thereto. The Dutch Competition Authority ensures compliance with European and Dutch competition laws.

Code of ethics

Franchisors that are members of the Dutch Franchise Association are bound by the rules in the European Code of Ethics for Franchising drawn up by the European Franchise Federation.

Fraudulent sale

24 What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

Besides the options under the Franchise Act and general civil law, a franchisee could benefit from the Acquisition Fraud Act and its possible consequences for the franchise practice. This act provides that a person acting in the course of a profession or business is acting unlawfully towards another professional party if he or she makes statements to the other party that are misleading in one or more respect. Incidentally, it is not only misleading if untruths are told, but also if essential information is omitted, such as information that the other party needed precisely to make an informed decision about the transaction in question. This act dictates that the party that made the announcements must state and prove that the announcements were correct and complete. In contrast to the 'normal' law of evidence, the other party is not obliged to prove that these communications were incorrect or incomplete. This results in a significant easing of the burden of proof for the injured party.

If a franchisor engages in fraudulent or deceptive practices, the franchisee may base a claim for annulment of the contract against the franchisor due to deceit, error or misrepresentation. If the actions or omissions of the franchisor also qualify as a civil tort, which is always accepted in cases of deceit, the franchisor has an obligation to compensate all of the franchisee's damages.

FRANCHISE CONTRACTS AND THE FRANCHISOR/ FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The Franchise Act, which came into effect on 1 January 2021, also regulates how the parties should act towards each other during the course of the franchise agreement. Namely, the franchisor should provide the franchisee with information during the relationship and both parties need to act as a 'good franchisor' and a 'good franchisee' respectively. This last concept is very comparable with a principle that already existed in Dutch civil law that parties need to act reasonably and fairly towards each other, and take into account the other parties' interests.

Operational compliance

26 What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

This depends highly on the situation in question and the applicable franchise agreement. Some franchise agreements have been in place for many years and generally the control mechanisms in those agreements are limited. However, most franchise agreements contain reporting and information obligations at minimum. Inspection and audit rights are less common, but can still be found, especially in franchise agreements that have been prepared following the implementation of the Franchise Act.

Amendment of operational terms

27 May the franchisor unilaterally change operational terms and standards during the franchise relationship?

If the franchisor intends to alter the franchise formula using a provision contained in the franchise agreement or intends to have a derived formula (operated directly or through third parties) without amending the franchise agreement, and the franchisor requires from the franchisee an investment, fee, surcharge or other financial contribution or can reasonably foresee that the implementation will lead to costs or loss of turnover, the following applies.

If the required monetary contribution exceeds a certain financial threshold set out in the franchise agreement, the franchisor requires prior consent to implement the plan in question from:

- a majority of the franchisees established in the Netherlands with whom the franchisor has concluded a franchise agreement concerning the franchise formula; or
- each of the franchisees established in the Netherlands that are affected by the intended plan.

Examples of an alteration of the franchise formula are the introduction of new product groups or new services (or disposal thereof), focusing the franchise formula on new target groups and exploring new marketing channels. Loss of turnover will likely occur if the franchisor intends to exploit a derived formula within the exclusive territory of the franchisee. In that event, the franchisor competes with its franchisees by using a derived formula directly operated by the franchisor or through third parties. It is advisable to add a financial threshold to the franchise agreement to determine the discretion of the franchisor regarding the alteration of the franchise formula or the use of a derived formula. This amount can be tailored to the type of franchise, the relevant sector and supply chain, and the size of the franchise enterprise. However, the proposed financial threshold requires the consent of the franchisee. If the financial threshold is not specified in the franchise agreement, prior consent will always be required from franchisees, regardless of the extent of the required investment, financial contribution, or costs or loss of turnover. The franchisor can benefit from the presence of a representative body of franchisees to obtain the necessary consent from the majority (that is, at least 50 per cent) of the franchisees. This could be less time-consuming than obtaining consent from the individual franchisees concerned.

Policy affecting franchise relations

28 Do other government or trade association policies affect the franchise relationship?

The European Franchise Code (EFC) implemented by the Dutch Franchise Association (NFV) may affect the franchise relationship when

the franchisor is a member of the NFV. For example, the EFC stipulates that the franchisor must provide the franchisee with initial training and continuing commercial and technical assistance during the entire term of the agreement.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Either party may have cause to terminate the franchise agreement in the case of a serious breach of obligations by the other party. The criteria for what constitutes a serious breach should be carefully considered before actually terminating, because Dutch courts have the discretion to decide that a certain circumstance does not qualify as a sufficiently serious breach, notwithstanding the fact that this may have been agreed by the parties in the franchise agreement.

In the case of termination of the franchise agreement by the franchisor without cause, a legal distinction should be made between contracts concluded for a definite and an indefinite duration. Contracts of definite duration can generally not be terminated before the end of the contract term unless the possibility to terminate early – without cause – has been specifically agreed upon. Early termination, in most situations, results in liability of the terminating party. If a franchisor terminates a contract for a definite term prematurely without cause, the franchisee can claim continued performance or damages. The damages could consist of lost profits calculated over the remaining term of the contract, and costs and investments that the franchisee was not able to redeem owing to the premature termination.

In the case of a contract for an indefinite duration, the leading view recently affirmed by the Dutch High Court is that the contract may in principle be terminated by either party. However, under certain circumstances, a franchisor may be obliged to present a good reason to terminate the agreement. Besides this, the franchisor must respect a reasonable notice period, the length of which depends on the circumstances of the matter. While until recently it was quite usual that courts granted termination periods of up to a maximum of six to 12 months, currently there are a couple of higher court decisions in which notice periods of two to three years have been granted, even when contractually the parties agreed to a shorter notice period. Furthermore, the franchisor may be obliged to compensate the franchisee upon termination for investments or costs that the franchisee may not be able to earn back as a result of the termination, as well as for over-stock (eg, taking back stock against a reasonable purchase price). So far, no high court has granted a franchisee payment of a goodwill or customer compensation, even though this has sometimes been suggested in literature. If the franchisor terminates a contract without cause or does not respect a reasonable notice period, the franchisee could claim continued performance during the period that should have been respected by the franchisor, or instead claim a financial compensation for damages.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

Either party may have cause to terminate the franchise agreement in the case of a serious breach of obligations by the other party. The criteria for what constitutes a serious breach should be carefully considered before actually terminating, because Dutch courts have the discretion to decide that a certain circumstance does not qualify as a sufficiently serious breach, notwithstanding the fact that this may have been agreed by the parties in the franchise agreement.

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In the case of a contract for an indefinite duration, the leading view recently affirmed by the Dutch High Court is that the contract may in principle be terminated by either party. However, the franchisee must respect a reasonable notice period, the length of which depends on the circumstances of the matter. If the franchisee terminates a contract without cause or does not respect a reasonable notice period, the franchisor could claim continued performance during the period that should have been respected by the franchisee, or instead claim financial compensation for damages.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

In practice, franchise agreements are often continued without the conclusion of a new formal agreement. Under Dutch law, no formal or substantive requirements apply.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Whether a franchisor may refuse to renew the franchise agreement with a franchisee depends primarily on the content of the agreement. Often, the possibilities and conditions for renewal are specified in the agreement. When there is no contractually agreed renewal mechanism, a franchisor may be able to terminate the relationship by not renewing the franchise agreement if it complies with a reasonable notice term. The franchisor may sometimes be required to compensate costs and investments of the franchisee and, in exceptional circumstances, a 'good reason' will be required. Furthermore, where the franchisor can prove that the franchisee is in breach of its material obligations, the franchisor may refuse to renew the agreement on the basis of breach of contract. In certain circumstances, the franchisor will be obliged to compensate the franchisee upon termination; for example, if the franchisor or a new franchisee takes over the franchise business, based on the Franchise Act the franchisor would be required to pay the franchisee a goodwill compensation. The calculation of the goodwill compensation should be specified in the franchise agreement.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

A general provision regarding contract transfers is set out in the Dutch Civil Code. A contracting party may, only with the consent of the other party, transfer its rights and obligations under the contract to a third party. Therefore, a franchisee may only transfer the franchise with the franchisor's consent. A franchisor will not normally refuse such a

transfer where the third party meets the selection criteria. It can be contractually arranged that the franchisee should first offer the business to the franchisor on the same terms as those that the franchisee would offer to the third party. Based on the Franchise Act, the franchisor must pay the franchisee a goodwill compensation in the event that it takes over the franchise business.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

Franchising fees are not regulated by law. In practice, however, different types of fee can be distinguished. First, an entrance fee, which is a one-off payment that the franchisee pays to the franchisor. It represents a contribution towards the costs that the franchisor has incurred in the expansion of its chain and establishment of goodwill. Second, a continuing franchising fee, which is a regular fee for the use of the franchise system. This is usually a percentage of profits that the franchisee has realised within a given term. A specific fee may also be due as a contribution towards advertising, promotional activity or technology costs.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

Under freedom of contract between professional parties, in principle the parties are free to agree on the interest rates to be applied. If the parties did not agree on any interest rate, Dutch statutory trade interest applies automatically in the event of late payment. If no payment term has been agreed, then it is set automatically at 30 days after having received the invoice. On 16 March 2013, a new act entered into force, implementing Directive 2011/7/EU to prevent payment delays in commercial agreements. This act gives creditors more opportunities to recover their claims. Even though professional parties can agree upon payment terms, the act dictates that only in exceptional circumstances can a payment term longer than 60 days be agreed upon. When acting with governmental agencies, the maximum payment term should be 30 days and only in exceptional circumstances can it be longer than this, but it may never exceed 60 days. Based on this act, a creditor can claim a minimum compensation of €40 for the costs of recovery. Under this act, the statutory trade interest is increased by 1 per cent. This act does not apply to transactions with private consumers. The Dutch legal interest rate in commercial matters as of 1 January 2021 amounts to an annual percentage of 8 per cent. For transactions with consumers, a lower annual interest rate of 2 per cent applies.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No, there are no laws or regulations restricting this ability.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are, in principle, enforceable. The franchisee typically commits itself for the duration of the contract (and following its termination) to keeping all details of the franchisor's business operations confidential. This typically extends to non-patented know-how materials. The franchisee is legally obliged to treat certain information received from the franchisor as confidential, according to the law on the protection of business secrets that has been in force since 17 October 2018. This law is based on the Directive 2016/943/EU on the protection of undisclosed know-how and business information (trade secrets) against their unlawful acquisition, use and disclosure. Although there may be a legal obligation to keep certain information confidential, it is still recommended to include a clear confidentiality clause in the franchise agreement, including a penalty clause in the event of confidentiality breaches. The courts have the right to mitigate such penalties and this right cannot be contractually excluded.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

In the Netherlands, general civil law is governed by the principles of reasonableness and fairness. In the Franchise Act, this is made specific with the introduction of the obligation that the franchisor must act as a 'good franchisor' and the franchisee must act as a 'good franchisee'. Those principles may not only supplement the existing contract and relationship, but may also derogate from the contract that the parties agreed upon at an earlier stage, in the event that such provision is, in the given circumstances according to the principle of reasonableness and fairness, unacceptable. The standard required to derogate from an agreed provision is high. Franchisors in particular should be aware that a provision in an existing contract that is very one-sided (eg, a provision that the franchise relationship may be terminated by the franchisor at any given moment, respecting a notice term of only 30 days), could be set aside by the principle of reasonableness and fairness, if such provision is unacceptable in the given circumstances.

It is not possible to predict what kind of provisions may be set aside, if any, as the court considers all relevant circumstances, including:

- the economic power of each party;
- the dependency of the parties from each other;
- the duration of the contract;
- the investments made by either party;
- what each party could reasonably expect from the other party; and
- all other relevant circumstances.

As a general rule, Dutch courts generally tend to protect weaker or smaller parties at the expense of economically stronger or larger parties. However, this certainly does not mean that, simply by being a weaker party, certain clauses will be set aside. This depends on all the circumstances of the matter.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

When dealing with a very small franchisee, there is a possibility that general conditions –even potentially including a standard franchise agreement, or a part thereof – may be annulled because of reflex action of articles 6:236–238 of the Dutch Civil Code. Those articles deal with the 'black' and 'grey' lists, which set out prohibited clauses in general conditions for consumers.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

The parties may agree to draw up contracts in whichever language they choose. However, based on the Franchise Act, it is arguable that disclosure documents, the franchised agreement and any related

documentation should be made available in a language that the franchisee understands.

Restrictions on franchisees

41 What types of restrictions are commonly placed on the franchisees in franchise contracts?

Some provisions (such as exclusive territories, restrictions on sources from whom a franchisee may purchase or lease goods or services, prohibitions on franchisees soliciting the franchisor's or other franchisees' employees, non-competition, governing law, dispute resolution, etc) are commonly placed on the franchisees in a franchise agreement. However, based on EU and Dutch competition laws, certain provisions would be void, for example restrictions on customers the franchisee may serve and the prices franchisees charges to its customers.

Courts and dispute resolution

42 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Franchise agreements generally contain a dispute resolution clause, in which a competent court or a form of arbitration is explicitly chosen. Arbitration through the Netherlands Arbitration Institute (NAI) is well regarded and is generally less expensive than the more internationally well-known International Chamber of Commerce (ICC) arbitration.

In cases where there is no valid arbitration provision, the subdistrict court is competent in smaller claims (ie, for amounts less than €25,000) and for particular issues, such as employment and rent-related disputes. Larger claims may be brought before the civil judge of the district court.

The NFV can assist with mediation for parties seeking out-of-court remedies.

The Netherlands Commercial Court (NCC) was created on 1 January 2019. It is a chamber in the Amsterdam District Court, where parties may litigate before the Dutch court in the English language. A matter may be submitted to the NCC where:

- the Amsterdam District Court or Amsterdam Court of Appeal has jurisdiction;
- the parties have expressly agreed in writing that proceedings will be in English before the NCC;
- the action is a civil or commercial matter within the parties' autonomy; or
- the matter concerns an international dispute.

Governing law

43 Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

Franchisors cannot derogate from the Franchise Act in a franchise agreement, even if foreign law has been agreed upon, when franchisees are operating in the Netherlands. If Dutch law is applicable but a franchisee is located outside the Netherlands, the franchisor may deviate from the franchise agreement to the detriment of a franchisee.

Arbitration – advantages for franchisors

44 What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

The principal advantages of arbitration are as follows.

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- Arbitration offers a choice regarding the language of proceeding; the regular courts in the Netherlands only accept the Dutch language (with the exception of the Netherlands Commercial Court).
- It is possible to agree on the country and area where the proceedings will be conducted.
- It is possible to choose the number of arbitrators and the time limitations.
- Arbitration is, generally speaking, finalised more quickly than regular court procedures.
- Arbitration may be dealt with by appointed experts instead of or in addition to lawyers.
- Involved parties can agree to observe secrecy in arbitration, whereas regular court proceedings are public.

The principal disadvantages of arbitration are that, in general, arbitration is much more expensive than regular court proceedings, regular court proceedings offer the possibility of appeal whereas arbitration does not and the quality of arbitration may not always be ensured. This depends on the arbitration forum, although NAI and ICC arbitration in general is of good quality.

National treatment

45 In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

In principle, there is no difference in the treatment of foreign and domestic franchisors. However, the Franchise Act states that franchisors with franchisees operating outside the Netherlands should be able to deviate from the binding provisions in the Franchise Act, even when Dutch law is applicable to the franchise agreement. Franchisors with franchisees operating in the Netherlands are not able to deviate from the binding provisions in the Franchise Act, even when another (foreign) law system is applicable to the franchise agreement.

UPDATE AND TRENDS

Legal and other current developments

46 Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

The new Franchise Act has been in effect since 1 January 2021. From this date, new franchise agreements concluded with franchisees operating in the Netherlands or renewals of franchise agreements with existing franchisees must comply with the mandatory provisions of the Franchise Act. Existing franchise agreements with a longer duration than two years from 1 January 2021 are subject to a transitional period of two years with regard to specific provisions, such as the rights of consent, non-compete and goodwill. As of 1 January 2023, all franchise agreements, including already existing agreements made prior to 1 January 2021, must fully comply with the Franchise Act.

New Zealand

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Franchising is very active in New Zealand. The last survey carried out in 2021 by Massey University and Griffith University confirmed that there are 590 business-format franchise systems operating. The sectors in which franchising operates include administration and support services (34 per cent), other services (14 per cent), retail trade (non-food) (11 per cent), accommodation and food retail (11 per cent), and transport, postal and warehousing (9 per cent).

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The Franchise Association of New Zealand Incorporated (FANZ) was formed in July 1996 and all members must comply with the FANZ Code of Practice and the Code of Ethics (the Code).

Compliance

All members must attest that they will comply with the Code and members must renew their certificate of compliance on an annual basis.

Disclosure

A disclosure document must be provided to all prospective franchisees at least 14 days prior to signing a franchise agreement. This disclosure document must be updated by franchisors every two years and must provide information including:

- a company profile;
- details of the officers of the company;
- an outline of the franchise;
- full disclosure of any payment or commission made by a franchisor to any adviser or consultant in connection with a sale;
- listing of all components making up the franchise purchase;
- references; and
- projections of turnover and possible profitability of the business.

Certification

The Code requires franchisors to give franchisees a copy of the Code and the franchisee must then attest that he or she has obtained legal advice before signing the franchise agreement.

Cooling-off period

All franchise agreements must contain a minimum seven-day period from the date of the agreement during which a franchisee may change its mind and terminate the purchase. The cooling-off period does not apply to renewals of term or resales by franchisees.

Dispute resolution

The Code sets out a dispute resolution procedure that can be used by both franchisor and franchisee to seek a more amicable and cost-effective solution to disputes. The Code requires all members to try to settle disputes by mutual negotiation in the first instance. This process does not affect the legal rights of both parties to resort to litigation.

Advisers

All advisers must provide clients with written details of their relevant qualifications and experience, and they must respect the confidentiality of all information received.

The Code of Ethics

All members must subscribe to the Code of Ethics, which sets out the way in which the Code of Practice should be interpreted.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

Most franchisors conduct business in New Zealand as an incorporated company. Sole traders and partnerships are used and occasionally a franchisor may be a trading trust. Joint ventures are uncommon in New Zealand.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

The Companies Act 1993 applies to all companies incorporated in New Zealand and to companies with an overseas shareholding. It does not apply to companies incorporated in another country, unless such a company has been registered as an overseas company on the New Zealand Register of Companies. If a trading trust is used, then the Trusts Act 2019 applies. The relevant agency is the Ministry of Business, Innovation and Employment.

Requirements for forming a business

5 | Provide an overview of the requirements for forming and maintaining a business entity.

A new company can be incorporated online at www.companies.govt.nz. The first step is to obtain name approval. Following this, an application to incorporate must be completed, naming all the directors and shareholders of the company, who must give written consent to act as directors and to become shareholders. The address of the registered office of the company and the address for service must be provided, and both must be New Zealand addresses.

All new companies must be incorporated online. The name approval fee is NZ$11.50 and the incorporation fee is NZ$131.55. Once an overseas shareholder holds 25 per cent or more of the shares in a company, that company must file financial accounts and be audited. Otherwise, if the shareholders pass a unanimous resolution that no auditor need be appointed then the company does not have to be audited. When incorporating a new company it is wise to have a separate constitution, otherwise the provisions in the Companies Act 1993 will apply. For example, any pre-emptive rights will only exist by way of a separate constitution and not in reliance upon the Companies Act 1993.

A company must comply with the Companies Act 1993 and the Financial Reporting Act 2013. In relation to the formation of a company, there have been changes (which came into effect on 1 May 2015) as follows:

- all companies incorporated in New Zealand must have a director who lives in New Zealand, or lives in Australia and who is also a director of an Australian-incorporated company; and
- all directors must provide their place of birth and date of birth.

In relation to maintaining records with the Companies Office, company authority will be granted to directors and also to certain authorised persons (such as the person who incorporates the company online) allowing them to maintain up-to-date company information on the Register of Companies (such as resignation or appointment of directors, change of addresses and filing annual returns).

Restrictions on foreign investors

6 | What restrictions apply to foreign business entities and foreign investment?

Pursuant to the Financial Reporting Act 2013, a company must be audited and must file financial statements if a large foreign business entity holds 25 per cent or more of the shareholding in a company, and, at the balance date for the two preceding account periods:

- the total assets for the company and its subsidiaries were more than NZ$20 million; or
- the total revenue was more than NZ$10 million.

In relation to foreign investment, there are no barriers to funds coming into New Zealand. If a foreign entity wishes to buy land in New Zealand and the land is greater than five hectares in area or will result in overseas investment in other 'sensitive' land (eg, foreshore or seabed, public parks and historic land), an application must be made to the Overseas Investment Office for consent to the purchase before it can proceed.

Taxation

7 | What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

The corporate tax rate for both resident and non-resident companies is 28 per cent. New Zealand has tax treaties with many countries – for example, in relation to Australia, Singapore, Japan and the United States the rate of non-resident withholding tax is 5 per cent for royalties. In relation to the United Kingdom and Canada, the rate is 10 per cent, and for Fiji, Indonesia, Malaysia and the Philippines, the rate is 15 per cent. The non-resident withholding tax must be deducted from all interest and royalty income before funds are repatriated. The overseas entity will be able to claim a tax deduction in the relevant country because a non-resident withholding tax certificate will be provided. If dividends are repatriated, a non-resident withholding tax of 15 per cent must be deducted.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

The Employment Relations Act 2000 applies in New Zealand. Union membership is voluntary, but there must be a written employment contract in relation to every employee of a franchisee. Strict procedures must be followed before employment can be terminated and any breach of these procedures could give rise to a personal grievance action that may cost the employer many thousands of dollars. Any properly drafted franchise agreement should contain a clause stating that a franchisor and a franchisee are not in a relationship of employer or employee, but that any franchisee must comply with New Zealand employment law.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

The Trade Marks Act 2002 is the relevant statute and all trademarks must be registered in New Zealand. The relevant body to deal with this is the Intellectual Property Office of New Zealand. Trademark registrations last for 10 years and must then be renewed. Know-how is protected by normal intellectual property laws and would be deemed to be included in the definition of trade secrets; any properly drafted franchise agreement will include know-how in the definition of intellectual property and should contain a robust intellectual property clause.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

All real estate in New Zealand is recorded by Land Information New Zealand, which provides a registered title for each piece of land. Titles can be freehold, leasehold, strata, cross-lease or some combination. If the property being purchased is on a unit title (which would mean that there would be a stratum estate of freehold under the Unit Titles Act 2010), an overseas franchisor can own land. However, if the land is greater than five hectares in area or will result in overseas investment in other 'sensitive' land (eg, foreshore or seabed, public parks and historic land), an application must be made to the Overseas Investment Office for consent to the purchase before it can proceed.

Franchisors can lease commercial buildings without restriction. If real estate agents are engaged, they must comply with the Real Estate Agents Act 2008. Franchisors who request real estate agents to find premises for them will have to pay an agreed commission to the relevant agents. The Property Law Act 2007 is also relevant in relation to real estate and must be consulted.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

The Commerce Act 1986 provides the regulatory framework relating to anticompetitive conduct and the Commerce Commission is charged with policing that framework. The Commerce (Cartels and Other Matters) Amendment Act 2017 made significant changes and replaced the previous prohibition on price-fixing between competitors with an expanded prohibition on cartel provisions, which extends to market allocations and output restrictions as well as to price-fixing by competitors.

The New Zealand cartel prohibition is very wide and will have a strong impact on franchise networks. Some additional clauses must be inserted into franchise agreements and there should be explanations as to why certain clauses are necessary. Consideration must be given to cartel clauses in franchise agreements. For example, clauses that set or influence prices, restrict output, or allocate markets will be impacted. The possibility that alternative arrangements might achieve the same or a similar commercial outcome as a cartel clause should also be considered. Another consideration is whether the collaborative activity exemption or the vertical activity exemption would apply. Expert legal advice should be obtained in relation to this act.

There will not be a cartel arrangement in place where parties are not in competition with each other. In most franchise systems, the franchisor will not be in competition with its own franchisees, but that is not always the case. For example, a franchisor that owns its own outlet might be found to be in competition with franchisees. Similarly, where a franchisor sells online directly to the end consumer, yet at the same time has franchisees who sell to those consumers, the franchisor may be in competition with its franchisees. There may also be instances where franchisees are in competition with each other. Where a franchisor is in competition with a franchisee or where franchisees are found to be in competition with each other, there will be a competitive relationship, so the franchisor needs to be cognisant that there may be provisions in its franchise agreements that amount to cartel provisions.

Consideration must also be given to the Commerce (Criminalisation of Cartels) Amendment Act 2019, which came into force on 8 April 2021 and introduced a new criminal offence for cartel conduct. The proposed new criminal sanctions reflect the covert nature of cartels and the harm they cause to consumers and the economy.

The Commerce Act 1986 provides a number of statutory exceptions that would not constitute a cartel arrangement and may be pro-competitive. These exceptions relate to collaborative activities (for example, joint ventures or franchise arrangements), joint buying, vertical supply contracts and specified liner shipping arrangements. There are no defences for mistakes of fact relating to the elements of joint buying or of promotion and vertical supply contracts. Therefore, it will be possible in the future for a director of a franchisor company to be criminally liable under the Commerce Act 1986 for a cartel offence. For an individual who commits an offence, the penalty on conviction could be imprisonment for a term not exceeding seven years or a fine not exceeding NZ$500,000, or both. For a company that commits an offence, the penalty could be up to NZ$10 million.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

There is no franchise-specific legislation in New Zealand, so there is no legal definition of a franchise. However, the Franchise Association of New Zealand Incorporated (FANZ) was formed in July 1996 and all members must comply with the FANZ Code of Practice. The Code of Practice, in section 2.1, defines 'franchise' as a business operated as a franchise, and that term is further defined in the rules as follows.

> *'Franchise' means the method of conducting business under which the right to engage in the offering, selling or distributing of goods or services within New Zealand includes or is subject to at least the following features:*
>
> - *the grant by a Franchisor to a Franchisee of the right to the use of a Mark, in such a manner that the business carried on by the Franchisee is or is capable of being identified by the public as being substantially associated with a Mark identifying, commonly connected with or controlled by the Franchisor;*
> - *the requirement that the Franchisee conducts the business, or that part of the business subject to the Franchise Agreement, in accordance with the marketing, business or technical plan or system specified by the Franchisor; and*
> - *the provision by the Franchisor of ongoing marketing, business or technical assistance during the term of the Franchise Agreement.*

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

No government agencies regulate the offer and sale of franchises. However, there are a number of laws that must be complied with, including the Commerce Act 1986, the Fair Trading Act 1986 and the Real Estate Agents Act 2008. If a broker is used by a franchisor to assist with the sale of franchises, then the following procedures will be relevant.

All real estate in New Zealand is recorded by Land Information New Zealand, which provides a registered title for each piece of land. Titles can be freehold, leasehold, strata, cross-lease or some combination. If the property being purchased is on a unit title (which would mean that there is a stratum estate of freehold under the Unit Titles Act 2010), an overseas franchisor can own land. However, if the land is greater than five hectares in area or will result in overseas investment in other 'sensitive' land (eg, foreshore or seabed, public parks and historic land), an application must be made to the Overseas Investment Office for consent to the purchase before it can proceed.

Franchisors can lease commercial buildings without restriction. If real estate agents are engaged, they must comply with the Real Estate Agents Act 2008. Franchisors that request real estate agents to find premises for them must pay an agreed commission to the relevant agents. The Property Law Act 2007 is also relevant in relation to real estate and must be consulted.

Principal requirements

14 | What are the principal requirements governing the offer and sale of franchises under the relevant laws?

A franchisor can offer a new franchise territory (a greenfield franchise) directly to a franchisee without having to comply with the Real Estate Agents Act 2008 provided that it is selling the franchises on its own behalf and not acting on behalf of a third party. If the franchisor appoints a real estate agent, then the real estate agent would need to be licensed under the Real Estates Agents Act 2008.

If a franchisee or business broker wishes to sell an existing franchise to a third party (who would be the incoming franchisee), then the business broker must be a real estate agent licensed under the Real Estate Agents Act 2008.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

There is no law in New Zealand that would create such a requirement. To become a member of FANZ, the association's rules require a franchisor member to have a written franchise agreement and disclosure document, be financially sound and have the appropriate authorities to franchise, and provide the board with such documentary verification as it requires to support membership.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

There are no laws, regulations or government policies that provide any restrictions in terms of this question. If a franchisor is a member of FANZ, it must provide any franchisee with its disclosure document, and the FANZ Code of Practice and Code of Ethics. The Code of Practice states that 'all members shall act in an ethical, honest and lawful manner and endeavour to pursue best franchise practice'. It also provides a cooling-off period for the franchisee and sets out a dispute resolution process to be followed.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

There are no franchising laws requiring pre-contractual disclosure but great care must be taken to ensure that all representations are true and do not amount to misrepresentations that will fall foul of the Fair Trading Act 1986. A member of FANZ must provide a potential franchisee with its disclosure document at least 14 days before the franchise agreement is executed and the disclosure document must be updated at least annually by the franchisor.

Pre-contractual disclosure – content

18 | What information is the disclosure document required or advised to contain?

The disclosure document must provide:

- the name, registered office and physical business address of the franchisor;
- the names, job descriptions and qualifications (if any) of the franchisor's directors, executive officers or principals;
- a detailed curriculum vitae of the business experience of the franchisor and any related entities, and those of its directors, secretary, executive officers or principals;
- a viability statement with key financial information of the franchisor;
- details of any bankruptcies, receiverships, liquidations, placements in administration or appointment of a statutory manager, or materially relevant debt recovery;
- details of any criminal, civil or administrative proceedings within the past five years;
- a summary of the main particulars and features of the franchise;
- a list of the components of the franchise purchase;
- details of any financial requirements by the franchisor of the franchisee;
- details of existing franchises, number of outlets and franchisor-owned outlets, franchises terminated over the past two years, and any unresolved litigation; and
- other information listed in the FANZ Code of Practice.

Pre-sale disclosure to sub-franchisees

19 | In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Legally, none is required. However, if a franchisor belongs to FANZ, it must comply with the Code of Practice and publish a disclosure document. A sub-franchisor would have to provide a disclosure document to a potential sub-franchisee if that sub-franchisor were a member of FANZ.

Due diligence

20 | What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

A representative of the franchisor will need to meet a potential franchisee a number of times. It is important for the potential franchisee to meet the directors of the franchisor company as the parties will be entering into a franchise relationship. The franchisee must obtain independent legal and accounting advice and the franchisor's disclosure document will contain a lot of useful and essential information about the franchisor. The franchisee must ask relevant questions and obtain answers to any statements contained in the disclosure document. The franchisee should speak to at least six existing franchisees in the system and ask them how they find the franchisor, the training, the support and other relevant information.

Failure to disclose – enforcement and remedies

21 | What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

If a sub-franchisor misrepresented the position without recourse to a franchisor, the franchisor should not be liable in any way. If a representation is made by a director or employee of the franchisor or the sub-franchisor, the protection of a limited liability company may not protect that individual, who may be personally liable pursuant to the Fair Trading Act 1986. There is a specific provision in that act in relation to employees being liable for personal misstatements while in their employment. There may also be liability pursuant to the Contract and Commercial Law Act 2017.

Failure to disclose – apportionment of liability

22 | In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

If a franchisee is permitted to enter into a sub-franchise agreement with a sub-franchisee, then the franchisee would be liable for any violations or breaches of the disclosure document. The franchisor would not

be liable in any way unless it has shared misleading information to the franchisee that is proven to be incorrect.

General legal principles and codes of conduct

23 | In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

Contractual principles under the law of contract would apply to the first question. The second question is not applicable where a franchisor is a member of FANZ, in which case both the Code of Practice and the Code of Ethics would apply.

Fraudulent sale

24 | What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

Franchisees could make a complaint to the Commerce Commission and request an investigation in relation to such activity. Such protection differs due to the fact that fraudulent or deceptive conduct should not occur in relation to franchise sales. Also, such franchisees could bring a civil action against the franchisor and it may be possible for the directors of the franchisor company to be called as separate defendants as they could be personally liable for damages if the franchisor company has no assets. This protection does not differ from the protection provided pursuant to existing civil laws in New Zealand.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 | What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

No specific laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect.

Operational compliance

26 | What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

The franchisee must allow the franchisor (or its representative) to visit the premises at any reasonable time during business hours. The franchisee must also keep and maintain books of account and financial records, and complete financial accounts as may be prescribed by the franchisor. The franchisee shall permit the franchisor to inspect or obtain copies of any written records during normal business hours. If the franchisor considers that there is any irregularity in the books of account, then it may nominate an independent auditor to carry out an audit. It is also important to check whether there is a separate marketing bank account and how this will be controlled.

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

Yes. The operating manuals can be updated and changed by the franchisor from time to time. All changes should be reasonable and in the best interests of the system, and all updates to the manuals are mandatory for all franchisees.

Policy affecting franchise relations

28 | Do other government or trade association policies affect the franchise relationship?

No government or trade association policies affect the franchise relationship.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Events that could lead to termination must be specified in the franchise agreement. There must be some default on the part of the franchisee for a valid termination to be confirmed. Also, it is usual and prudent for a notice of breach of franchise agreement to be issued by a franchisor to a specific franchisee and for the time limit for remedying the breach to have expired before the termination takes place. If a termination is unlawful, a franchisee would be able to seek redress from a court, with the remedies being either damages or an order from the court that the franchise be reinstated to the franchisee, which may then continue to conduct business pursuant to the franchise agreement.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

A franchisee may terminate a franchise relationship only if the franchisor has engaged in misrepresentations or fraudulent conduct as an inducement for the franchisee to enter into the franchise agreement in the first place. Termination would be pursuant to specific sections as set out in the Contract and Commercial Law Act 2017. Further, if a franchise agreement specifically allows the franchisee the right to terminate on, for example, six months' notice, the franchisee would be able to give such notice if required to exit the franchise but would lose the right to sell its business and recoup the upfront franchise fee together with any goodwill paid to the franchisor.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

All rights of renewal must be contained in the franchise agreement, which would normally set out the procedure for the franchisee to activate a renewal of term. Normally the franchisee must not have breached the agreement during the current term and the renewal option is normally exercisable by a franchisee giving the franchisor notice in writing not less than three months and not more than six months prior to the end of the current term. It is usual for a renewal fee to be paid by the franchisee to the franchisor and the amount of the renewal fee should be stated in the franchise agreement.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

A franchisor may refuse to renew its franchise agreement with a franchisee if some provisions in the franchise agreement allow it to do so.

If a franchisee has breached the franchise agreement in a material way during the term, or if two or more breach notices have been issued within a 12-month period, the franchisor may be able to block any renewal, provided the franchise agreement contains such a relevant clause. Further, if a franchisee is in default at the time of purporting to renew a franchise agreement, the franchisor could prevent such renewal.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

A franchisor may restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity provided the franchise agreement contains a right of first refusal clause in favour of the franchisor. Further, any transfer or sale of a franchise by a franchisee is always subject to the consent of a franchisor, who should be able to say no without giving any reasons. The precise wording in any assignment or transfer clause is very important and if a franchise agreement contains such words as 'with such consent not to be unreasonably or arbitrarily withheld', then it would be harder for a franchisor to refuse consent.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

There are no laws or regulations affecting the nature, amount or payment of fees, but should an unfair interest rate be imposed – for example, 30 per cent or 40 per cent – the equitable doctrine of unjust enrichment may be available to assist a disgruntled and unfairly treated franchisee.

The Supreme Court in New Zealand has ruled that a penalty clause will be enforceable unless it is 'out of proportion' with the innocent party's legitimate interests in having the contract performed. The relevant case is *127 Hobson Street Ltd v Honey Bees Preschool Ltd* [2020] NZSC 53.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

There are no restrictions on the amount of interest that can be charged on overdue payments. However, any ridiculous or oppressive amount is likely to be challenged by a franchisee or a franchisee's lawyer. If a franchisor wants to charge such a high rate of interest that it would be in the nature of an unjust penalty, then that rate of interest may be unenforceable by the court. The details of the case *127 Hobson Street Ltd v Honey Bees Preschool Ltd* [2020] NZSC 53 may be useful for reference.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

Laws and regulations exist restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic country. In all cases, non-resident withholding tax would have to be deducted. New Zealand has double taxation treaties in relation to many countries, so any tax paid in New Zealand by an overseas franchisor in relation to the repatriation of income should be able to be claimed as a tax credit in the franchisor's foreign country.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are important and they are enforceable as it is essential for a franchisor to be able to protect the integrity of all proprietary information.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

There is no legal obligation for parties to act in good faith enshrined in New Zealand legislation. However, it is common and to be encouraged for good faith clauses to be inserted in all franchise agreements that apply to both franchisor and franchisee. The courts in New Zealand are moving towards implying a duty of good faith, but this has not happened yet. Both parties should act loyally and in good faith towards each other at all times, as that is the essence of any franchise relationship.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

New Zealand's current consumer law may cover business-to-business relationships and accordingly franchisors must contract out of consumer protection legislation such as the Consumer Guarantees Act 1993 and the Fair Trading Act 1986 to the fullest extent possible.

The Fair Trading Act 1986 (FTA) was amended by the Fair Trading Amendment Act 2013, and further, the Fair Trading Amendment Act 2021 comes into force on 16 August 2022. The FTA has new obligations and restrictions relating to unfair contract terms, unsubstantiated representations, extended warranties, shill bidding, unsolicited goods and services, uninvited direct sales and lay-by sales, consumer information standards, product safety and product recalls, internet sales and auctions and auctioneers. The FTA also has a new right to contract out of certain provisions of the FTA in business contracts. Penalties for contravening the FTA go up to NZ$200,000 for individuals and NZ$600,000 for companies.

The Consumer Guarantees Act 1993 (CGA), which was amended by the Consumer Guarantees Amendment Act 2013, includes new guarantees relating to delivery and the supply of electricity and gas. It also has new obligations and restrictions relating to:

- contracting out of the CGA;
- collateral credit agreements; and
- indemnification of gas and electricity retailers.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

There is no legal requirement for disclosure documents and franchise agreements to be written in English, but since the major language of New Zealand is English, all parties would insist that English is used.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

A franchise agreement imposes certain restrictions on the franchisee and some examples include the following:

- There may be a defined exclusive territory with a map attached or a non-exclusive territory.
- There is normally an obligation on the franchisee to use the approved suppliers as stipulated by the franchisor.
- The agreement will normally contain a restraint on competition for a certain area and duration.
- The agreement should contain a robust dispute resolution clause to be activated if there is a dispute between the parties. Normally mediation is recommended but some agreements require arbitration. This is a matter of contract.
- The agreement will contain a governing law clause and it will be subject to the exclusive jurisdiction of the courts in a stated country.

All franchise agreements must comply with the Commerce Act 1986 and the Fair Trading Act 1986. It is very important for both franchisors and franchisees to understand the implications raised by the Commerce Act 1986.

Key changes introduced in the Commerce (Criminalisation of Cartels) Amendment Act 2019 are detailed below.

Cartel conduct restrictions

New cartel conduct restrictions are as follows:

- the previous restriction on competitors fixing prices; and
- new restrictions on competitors jointly restricting output and market allocation.

These new restrictions will have the most far-reaching impact on business.

Collaborative activity exemptions

This is a new cartel exemption for permitted collaborative activities. Competitors will be able to seek clearance for proposed collaborative activities, providing certainty that the proposed activities will not breach the Commerce Act 1986.

Vertical supply contract exemption

This is a new exemption for cartel provisions that are included in vertical supply contracts where certain requirements are met.

International liner shipping exemption

This is a new exemption for international liner shipping from the prohibitions against anticompetitive agreements and cartels.

Because the new cartel legislation impacts upon key areas contained in franchise agreements, it is very important to explain the basis of a number of clauses that are commonly inserted in franchise agreements. Such clauses include approved products, approved services, restraint area, restraint period and location of a franchised operation.

Courts and dispute resolution

42 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The lowest level court in New Zealand is the district court, which can determine claims involving up to NZ$350,000. For claims exceeding NZ$350,000, the High Court of New Zealand is the relevant body. Appeals from the High Court of New Zealand go to the Court of Appeal of New Zealand, which sits in Wellington. Appeals from the Court of Appeal go to the Supreme Court of New Zealand, which also sits in Wellington.

If a franchisor belongs to FANZ, the franchise agreement must contain a dispute resolution clause. The Code of Practice prescribes that mediation is mandatory, and it has a high chance of success.

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There is also the Arbitration Act 1996. A domestic franchisor who is not a member of FANZ can resort to court action, but the courts usually require an attempt to resolve the dispute by way of mediation. A foreign franchisor could issue proceedings in New Zealand and sue a particular franchisee, but again, the courts may require an attempt to settle any dispute by way of mediation. The governing law in any franchise agreement is important and most foreign franchisors require the governing law to be that of their home country. At the same time, it is recommended that foreign franchisors should stipulate that the governing law should be the law of New Zealand, as it is far easier to take swift action in relation to a defaulting master franchisee or franchisee through the New Zealand courts and to apply New Zealand law.

There is also the Disputes Tribunal whereby disputes between parties can go to a hearing before a referee with no lawyer representation allowed. The maximum amount of any claim is NZ$30,000.

Governing law

43 Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

There are no such restrictions. The choice of governing law is very important. If New Zealand is chosen as the jurisdiction where the contract is to be enforced and a judgment is obtained, then the Reciprocal Enforcement of Judgments Act 1934 applies.

Arbitration – advantages for franchisors

44 What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

The principal advantages of arbitration include the fact that a hearing date would usually be much earlier than a court hearing date, the costs should be lower than the costs of litigation, any arbitration is confidential between parties so the result will not appear in the press or elsewhere, and it should be more informal than litigation in the High Court. Disadvantages include the fact that one party may want publicity but will not get it and enforcement of the arbitral award that may have to go down the path of litigation. Mediation is strongly favoured over arbitration in New Zealand and the FANZ Code of Practice sets out mediation in great detail.

National treatment

45 | In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Foreign franchisors must still comply with the laws of New Zealand insofar as they affect them. The only way they would be treated differently from domestic franchisors may be in the area of taxation, where income of any sort that is to be repatriated from New Zealand to an overseas jurisdiction will be subject to non-resident withholding tax.

UPDATE AND TRENDS

Legal and other current developments

46 | Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

The Fair Trading Amendment Act 2021 was passed to extend the existing prohibition on Unfair Contract Terms (UCT) to standard form small trade contracts worth under NZ$250,000 (including GST) and introduced a new statutory prohibition on unconscionable conduct.

These changes will come into force on 16 August 2022. If a standard form small trade contract is signed prior to this date then the UCT regime will not apply however if the contract is amended or varied after 16 August 2022 and it falls within the definition of small trade contracts then the new amendments will apply to that varied/renewed contract.

Trends in franchising in New Zealand suggest that more multi-unit ownerships by franchisees will evolve.

Norway

Eline Thorsrud and Kjetil Vågen*

CLP

MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Franchising is a common way of organising chains within certain sectors in Norway. The sectors with the highest use of franchising are the retail and food industry, more specifically:

- the food sector including cafés, restaurants and similar establishments;
- specialist trade, such as construction materials, paint and furnishing;
- services, such as healthcare, accounting and safety products;
- textiles and shoes; and
- grocery stores, convenience stores and fuel stations.

Other sectors that use franchising are hotels, opticians, jewellers, gyms, health and wellbeing centres, hairdressers, beauty salons, and car accessories and tyres.

There are no specific economic or regulatory issues in the market for franchising as opposed to other ways of organising chains.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

There are no national or local franchise associations in Norway.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

There are several relevant forms of business entities, from partnerships or entities with personal liability to public or private entities with limited liability. The most common are private or public limited liability companies, due to the limitations of the potential liability assumed as a shareholder. The private form has less extensive compliance requirements than the public form and is widely chosen in Norway.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

The establishment of a private limited liability company is governed by the Private Limited Liability Companies Act, while the establishment of a public limited liability company is governed by the Public Limited Liability Companies Act. Both acts set out similar rules and procedures for establishing a company, with requirements for the memorandum of association and minimum share capital.

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

The incorporation of a new company can be done within a short time frame and is done by executing a memorandum of association, which includes but is not limited to the company's articles of association and an opening balance of the company. The opening balance must at least correspond with the minimum requirement for share capital. For a private limited company, the limit is currently 30,000 Norwegian kroner. For a public limited company, the minimum share capital requirement is 1 million Norwegian kroner. For both forms of entity, the share capital may be freely used by the new company once paid up (eg, to pay the costs of incorporation).

The articles of association may be very simple and the minimum requirements for both forms of entity are:

- the name of the new company;
- the municipality of the new company's registered office;
- the new company's business;
- the amount of share capital; and
- the nominal value of the shares.

For public companies, the following must also be included:

- the number of shares;
- the exact number or the minimum and maximum number of directors;
- whether the company is a public limited liability company;
- provisions regarding general managers; and
- the matters to be dealt with by the ordinary general meeting.

The new company must be registered with the Norwegian Register of Business Enterprises within three months from the date of incorporation, notably when the memorandum of associations is executed. There is no requirement of attestation by a public notary. Before the new company can be registered, payment for the subscribed shares of the company must be made in full to a designated bank account in the name of the company.

Registration of a new company generally takes up to two weeks. This is, however, affected by the fact that all non-Norwegian directors need a D-number, which is the equivalent of a Norwegian social security number for foreigners. The D-number application process generally takes two to three weeks and must be made in conjunction with the application for registration of the new company. Together with a signed application form, each applicant must enclose a copy of valid proof of identity certified by accepted authorities, such as a Norwegian public authority, a Norwegian lawyer, a certified accountant, a state-authorised auditor or a foreign entity with notary powers.

Prior to registration, a private or public limited company can, as a starting point, only take on rights or obligations towards third parties to the extent that such rights or obligations are specified in the memorandum of association or follow from applicable law. However, the new company may enter into agreements and assume rights and obligations from incorporation (ie, prior to registration) without personal liability for the person acting for it, if this is agreed with the counterparty.

Both forms of entity must hold an ordinary general meeting within six months from the end of each financial year to approve the annual financial statement and the annual report of the company, among other matters.

Restrictions on foreign investors

6 | What restrictions apply to foreign business entities and foreign investment?

Foreign business entities are not subject to specific restrictions and may establish a business in Norway pursuant to the generally applicable laws and regulations. Foreign investments, either to be made by a foreign business entity or a foreign person, are not subject to specific restrictions.

Taxation

7 | What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

Companies and individuals who are tax-resident in Norway are taxed on their worldwide income. Partnerships are transparent for Norwegian tax purposes.

Companies and individuals who are not tax-resident in Norway but derive income from sources in Norway may have limited tax liability to Norway on this income. This mainly applies to income from business activities conducted in Norway, dividends from companies residing in Norway, income from real or movable property situated in Norway and income from employment undertaken in Norway.

Income from business activities

With respect to income from business activities in Norway, it follows from most tax treaties that the business activities must be conducted through a permanent establishment in order to be taxable in Norway.

A non-resident company with business activities in Norway is liable for Norwegian tax on all net income attributable to the business activities and is taxed at the same rate as companies resident in Norway (the normal corporate tax rate for 2021 is 22 per cent). A non-resident individual with business activities in Norway is taxed as self-employed for income attributable to business activities by progressive tax rates of up to 49.6 per cent, including the national insurance contribution. A non-resident company or individual participating in business activities through a partnership is taxed at a maximum of 46.7 per cent for its part of the net income.

Income from resident companies

Dividends from resident companies to non-resident shareholders are subject to a 25 per cent withholding tax unless a lower rate is set in the applicable tax treaty. Exemptions may also follow from the Norwegian participation exemption model, which to a large degree exempts companies residing within the European Economic Area or European Union from paying tax on dividends from companies residing in Norway.

With respect to capital gain on shares, Norwegian legislation does not impose limited tax liability on non-residents. Norway does, however, have limitations on deductions for intra-group interests. From 1 July 2021, Norway will also introduce withholding tax on interests and royalties to related parties in low-tax countries.

Income from property

Net income and gain from real or movable property situated in Norway are taxed as capital income at a rate of 22 per cent when the property is not part of or itself constitutes a business. Real property in Norway is also largely subject to municipal property tax and stamp duty.

Income from employment

When it comes to income from employment exercised in Norway, non-resident individuals may be taxable to Norway on this income if the remuneration is paid by, or on behalf of, an employer who is liable to tax in Norway (either by tax residency or limited tax liability). Most tax treaties additionally require that the employee's presence in Norway exceeds 183 days in a 12-month period (which, according to Norwegian domestic legislation, would qualify the employee as a Norwegian tax resident). In the case of hire-out labour, however, the source of the payment or the length of the stay is of no importance. In this case, it is sufficient for Norwegian taxability that the employee is at the disposal of others within Norway. Income from employment is taxed at a progressive tax rate of up to 46.4 per cent, including the national insurance contribution.

Value added tax

Norway has a value added tax (VAT) system similar to other European countries. Foreign companies and individuals with business activities in Norway need to register for VAT when the sum of supplies and withdrawals covered by the Norwegian VAT Act exceeds 50,000 Norwegian kroner during a 12-month period. The general VAT rate is 25 per cent.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

A franchisor cannot impose terms in the franchise agreement that are contrary to or in breach of the mandatory provisions of the Working Environment Act or the Holiday Act (eg, in relation to opening and working hours).

Generally, the franchisor exercises power and influence over the franchisee without being considered the employer of the franchisee or employees of a franchisee. However, if the franchisor singularly controls, instructs and supervises the terms of the franchisee's business – for example, the extent and timing of orders of goods, opening hours and terms of the employees of the franchisee – or the franchisee has no responsibility for the financial risk, there is a risk that the franchisor may be deemed an employer of the franchisee or the employees of a franchisee. By including regulations in the franchise agreement that limit the control, instruction and supervision rights of the franchisee's business, the franchisor mitigates the risk of the franchisee or employees of the franchisee being deemed employed by the franchisor.

Intellectual property

9 How are trademarks and other intellectual property and know-how protected?

Trademarks

Pursuant to the Norwegian Trademark Act, a trademark can be obtained either by registration with the Norwegian Industrial Property Office (NIPO) or through such continuous use of a particular mark in the course of trade that the target group perceives the mark as a trademark.

An application can be filed with either NIPO for a Norwegian trademark or with the European Union Intellectual Property Office for an EU-wide trademark, which will have effect in Norway and all EU member states.

A registered trademark remains protected for 10 years from the date of application, with the possibility of renewal in perpetuity. However, this presupposes that the owner of the trademark without reasonable cause has ceased to use the mark for a continuous period of five years. A trademark right obtained through use remains in force until the owner seizes the use of the trademark as described above and thus it is no longer is perceived as a trademark by the target group. A trademark right obtained through use or registration entails that the owner holds an exclusive right to use the trademark or similar trademarks for the goods and services set forth in the registration or for which the trademark is used, as well as similar goods and services.

Ownership of copyrighted material is not registerable and comes into existence at the time of creation. Design rights may be registered for designs that are new and have individual character, and may be in force for up to 25 years.

Know-how

The term 'know-how' is not explicitly defined in Norwegian law. Nevertheless, it may constitute a trade secret pursuant to the newly adopted Trade Secrets Act. The Trade Secrets Act implements the Directive (EU) 2016/943 on the protection of undisclosed know-how and business information (trade secrets) against their unlawful acquisition, use and disclosure. Previously, trade secrets were regulated by the Marketing Practices Act and the Criminal Act.

Following the adoption of the Trade Secrets Act, which came into force on 1 January 2021, trade secrets are legally defined in accordance with the directive. The directive by and large conforms with the previous definition in Norwegian case law. To qualify as a trade secret, know-how must be secret in the sense that it must not be generally known or easily accessible, it must have commercial value because it is secret and the owner must have taken reasonable steps to keep it secret.

The Trade Secrets Act further introduced more detailed and strengthened regulations on how to enforce one's rights in the event of infringement, including a legal definition of infringement.

Real estate

10 What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

Domestic and foreign franchisors are not treated differently in the Norwegian real estate market pursuant to the relevant laws and regulations.

Most commonly, the franchisor leases the premises and sublets the premises to the franchisee pursuant to a sublease agreement. The Tenancy Act applies to commercial leases, but the parties are to a large extent free to deviate from the Tenancy Act. In Norway, there are unofficial templates for commercial lease agreements that are generally accepted as market practice and the basis for further negotiations. However, owing to the nature of franchising, the franchisor should make sure to adjust the templates to meet the needs of a franchisor either in the position as a lessee or a sub-lessor. For example, if the franchisor is the lessee, the franchisor should include a clause in the franchise agreement stating that said agreement terminates if the lease agreement terminates, no matter the cause of such termination. If the franchisee leases the premises directly from the lessor, the franchisor should include a clause in the franchise agreement granting the franchisor a right to take over the lease in the event of the termination of the franchise agreement or a material breach of the lease agreement by the lessee. Correspondingly, the franchisor should make sure to ensure the inclusion of this right in the lease agreement between the lessor and the franchisee as lessee to have an enforceable right to the transfer.

The direct purchase of real estate in Norway is regulated by the Sale of Real Estate Act. If none of the parties is a consumer, as is generally the case in sales of commercial real estate, the parties are free to deviate from the provisions of the Sale of Real Estate Act. Unofficial templates for the direct sale of commercial real estate are commonly accepted as market practice and are widely used in the Norwegian commercial real estate market. To obtain the legal protection of the acquisition and to be registered as the title holder of a property in the official entries recorded in the Register of Land and Land Charges, a signed deed must be submitted to and registered with the Land Registry. Stamp duty of 2.5 per cent of the property's market value applies to the transfer of title.

Competition law

11 What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

Agreements, including franchising agreements, are regulated by the Competition Act. Norway is a part of the European Economic Area (EEA) through its membership in the European Free Trade Agreement. The regulations in the EEA, which mirror those of the European Union, have been implemented into Norwegian legislation through special acts and regulations. Consequently, the Competition Act is partly harmonised with EU competition rules and, in practice, the material rules are identical to the rules in the European Union.

The European Commission's Block Exemption Regulation on Vertical Agreements (the Block Exemption Regulation) is incorporated into the Norwegian Regulation on the Application of the Competition Act (section 10(3)) on vertical agreements and concerted practices. This is particularly relevant to franchise agreements. If the franchise agreement falls under the Block Exemption Regulation, the application of competition law is precluded. The applicability of the Block Exemption Regulation presupposes that the market share held by the supplier does not exceed 30 per cent of the relevant market in which the supplier sells its goods or services and the market share held by the buyer does not exceed 30 per cent of the relevant market in which the buyer purchases those goods or services.

Article 5 of the Block Exemption Regulation sets out that a non-compete obligation can only be legally enforced for up to five years. If certain conditions are met, however, it can be enforced for the entire term of the contract and for another year after termination of the agreement. In order for the extended time period to apply, the obligation must concern competing goods or services, be limited to the geographic area from which the buyer has operated during the contract term and be indispensable to protect know-how transferred by the supplier to the buyer.

Nevertheless, the European Commission generally considers exclusivity clauses in franchising agreements justified if the franchise entails a significant transfer of know-how from the franchisor to the franchisee and the non-compete obligation is necessary to protect this transfer of know-how.

Enforcement of competition law in Norway

Competition law cases are heard by the ordinary courts. However, in the case of a potentially anticompetitive merger or acquisition, the Norwegian Competition Authority (NCA) enforces competition rules based on notifications from the entities in question. Notification is mandatory if the transaction entails a permanent change of control, and the involved undertakings exceed the turnover thresholds in the Competition Act.

The competition rules in Norway do not materially differ from the European Union Merger Regulation (Council Regulation (EC) No. 139/2004) (EUMR). However, there is a special provision in the Competition Act that allows the NCA to impose notification on and forbid a minority acquisition that significantly restricts competition. Consequently, the NCA may intervene in relation to transactions that do not fall within the scope of the EUMR.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

There is no statutory definition of a franchise in Norwegian law. Traditionally and unofficially the definition of a franchise is, according to Cappa in 2012:

> *Franchise is an operating model based on a collaboration between two independent parties (franchisor and franchisee). Against direct or indirect financial remuneration, the right to establish and operate the franchisor's business concept is distributed. The terms of operation of the franchisee's business as well as the cooperation between the parties are determined in a legal agreement.*

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

There are no laws or government agencies specifically regulating the offer and sale of franchises. Relevant Norwegian laws to be taken into consideration are, among others:

- the Contracts Act;
- the Sale of Goods Act;
- the Competition Act;
- the Working Environment Act;
- the Holiday Act;
- the Personal Data Act;
- the Marketing Control Act;
- the Tenancy Act; and
- the Act Relating to Product Liability.

There are no exclusions from these laws that are applicable only to the offer and sale of franchises.

Principal requirements

14 | What are the principal requirements governing the offer and sale of franchises under the relevant laws?

Since there are no laws or government agencies specifically regulating the offer and sale of franchises, the parties enjoy contractual freedom but must comply with statutory principles and the rules tjat govern the limits of contractual freedom. Both the Contracts Act and non-statutory contractual principles give a relevant legal basis for considering whether, and determining the consequence of, a contract being partially or wholly invalid. For example, failure to comply with non-statutory principles (eg, by not disclosing material information to the counterparty, or giving misleading information material to a franchisee considering to enter into a franchise relationship with the franchisor) may lead to the contract being considered partially or wholly invalid by the courts, with a subsequent potential entitlement to compensation or price reduction for the franchisee.

Regarding the transfer of business undertakings, the provisions in the Working Environment Act entails that the rights and obligations of the former employer issuing from the contract of employment in force at the date of transfer must be transferred to the new employer. Further, the new employer is bound by any collective pay agreements the former employer was bound by unless the new employer (within three weeks from the date of transfer) declares otherwise. Irrespective of such an announcement, transferred employees have the right to retain their individual working conditions that follow from the relevant collective pay agreement. The employees may object to the transfer of their employment relationship to the new employer, but the transfer of an undertaking to another employer is not in itself grounds for dismissal with notice or summary dismissal for the employer. However, if the transfer leads to redundancy of employees, the employer may dismiss employees in accordance with the rules of downsizing in the Working Environment Act.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

There are no such eligibility requirements or guidelines applicable to the offer of franchises.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

There are no such legal restrictions or requirements.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

There is no specific legislative compliance procedure for pre-contractual disclosure in Norway, and it is up to the parties to agree on a due diligence process and the terms for such due diligence.

However, the parties are bound by general contractual principles that require each party to provide the counterparty with relevant and necessary information before entering into a contractual relationship. Further, these general principles are continuous by nature, hence the parties are obligated to make further disclosure when relevant throughout the franchise relationship. Although there is no obligation for a cooling-off period under Norwegian law prior to when a binding agreement is entered into between a franchisor and a franchisee, we often recommend the franchisor to use such a cooling-off period for complex franchise agreements in order to secure that the franchisee has had sufficient time to review the franchise agreement. The aim of this is to limit the risk of potential claims from the franchisee related to clauses in the franchise agreement that the franchisee has not fully understood.

Pre-contractual disclosure – content

18 What information is the disclosure document required or advised to contain?

There is no explicit or exhaustive list of information required to be disclosed under general contractual principles, but information that is considered to be of major importance to the counterparty should be disclosed, including but not limited to financial risks, profitability, pending litigation or the current status of trademark registrations.

Pre-sale disclosure to sub-franchisees

19 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

The sub-franchisor is responsible for pre-sale disclosure and is bound by the same principles as the franchisor.

There is no specific legislative compliance procedure for pre-contractual disclosure in Norway, and it is up to the parties to agree on a due diligence process and the terms for such due diligence.

However, the parties are bound by general contractual principles that require each party to provide the counterparty with relevant and necessary information before entering into a contractual relationship. Further, these general principles are continuous by nature and the parties are obligated to make further disclosure when relevant throughout the franchise relationship.

Due diligence

20 What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

It varies from one franchise relationship to another, but there are some common recommendations. From the franchisor's perspective, it is recommended to carry out at least a limited due diligence procedure of the prospective franchisee, depending on whether the entity in question is an established business within franchising or similar. As a minimum, it is customary to carry out limited financial due diligence of annual accounts, order books and customer base, limited legal due diligence of the terms of the current chain agreement (if relevant) and the most important agreements of the entity. This is especially important when an entity changes from one chain to another as there may be regulation regarding this situation (ie, liability, termination and non-compete clauses that may affect whether and when the entity may start in the new chain). It is also recommended to undertake thorough interviews with the owner of the prospective entity and its management (if relevant) to confirm competence and personal fit with the chain.

From the franchisee's perspective, it is most important to undertake a thorough legal and financial review of the terms of the chain agreement, especially the financial terms and obligations for the franchisee, termination clauses and non-compete restrictions, as well as estimates and budgets (if available) for the franchisee's business going forward. The entity considering a contractual relationship with a chain as a franchisee should also consider requesting the opportunity to talk with the franchise manager of the chain, other owners of franchisee entities already established in the same chain and possibly the chain board (if relevant) to get a sense of the culture and relations within the chain.

Failure to disclose – enforcement and remedies

21 What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

No government agency enforces the disclosure requirements and it is up to the parties involved to ensure that their right to disclosure is met by the other party. If not otherwise resolved amicably between the party, the franchisee must initiate legal proceedings to obtain relief, specifying the basis for the claim and a calculation of the economic loss incurred due to the franchisor's breach of the principles. Depending on the requirements in the franchise agreement, the legal proceedings may be subject to the process of the ordinary courts or arbitration.

Liability is based on each party's breach of its disclosure obligations and three basic conditions must be fulfilled to impose liability. There must be a liability for damages, an economic loss, and a causal link between a concrete act or omission and the actual claim. Liability may be based on negligent, intentional or fraudulent behaviour.

Employees of the franchisor are generally not held personally liable as their actions or omissions are usually covered by the employer's liability for its employees pursuant to the Damages Compensation Act.

Both the Private Limited Liability Companies Act and the Public Limited Liability Companies Act set out the legal basis for personal liability for officers or directors of the company acting with negligence or intent. The general manager and members of the board of directors may be held liable for any damage they, in their respective capacities, have intentionally or negligently caused to the company, a shareholder or others.

Failure to disclose – apportionment of liability

22 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Liability for disclosure violations is not different for franchising and sub-franchising. The same principles apply and a potential division of liability between a franchisor and a sub-franchisor must be assessed on a case-by-case basis. The same applies to whether employees, officers and directors may be held liable.

General legal principles and codes of conduct

23 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

In addition to legislative requirements, general contractual principles are widely accepted in case law and apply in contractual relations. The most important principles are the non-statutory principles of *culpa in contrahendo*, the duty of loyalty and a duty of good faith, as well as the general principle of good business practice set out in the Marketing Practices Act.

Fraudulent sale

24 What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

If a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises, the franchisee may make

claims of compensation and initiate legal proceedings based on the Contract Law or general contractual principles, or both. The fraudulent party may be held liable for the other party's losses and contractual limitations of liability will not apply. Hence, the counterparty is, to a greater extent, entitled to claim indirect losses. Further, the contract may be deemed wholly or partially invalid, which may be an alternative ground for compensation or price reduction for the franchisee.

Fraud is a criminal offence under Chapter 30 of the Penal Code and a franchisee may report criminal offences to the police, who will decide if there is a basis to initiate a criminal investigation.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 | What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There is no legislation specific to franchises in Norway. Depending on each franchise relationship, there may be a number of relevant laws, regulations and guidelines. Relevant Norwegian laws to be taken into consideration are, among others:

- the Contracts Act;
- the Sale of Goods Act;
- the Competition Act;
- the Working Environment Act;
- the Holiday Act;
- the Personal Data Act;
- the Marketing Control Act;
- the Tenancy Act; and
- the Act Relating to Product Liability.

Operational compliance

26 | What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

It is common to include both inspection and audit rights for the franchisor.

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

It depends on the contract and whether the parties have agreed that the franchisor will have this right. Note, however, that the duty of loyalty and good faith as well as the Contracts Act set limitations on new terms that are deemed unreasonable.

Policy affecting franchise relations

28 | Do other government or trade association policies affect the franchise relationship?

No.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

The terms for the franchisor's right to terminate with or without cause are usually stated specifically in the franchise agreement, alongside a specification as to whether either basis for termination gives the right to immediate termination or the termination is subject to a notice period, which is usually between six and 12 months.

If the franchise agreement does not include a clause regarding termination rights, the franchisor may still terminate the agreement with immediate effect upon a material breach of the contract by the franchisee.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

The terms for the franchisee's right to terminate with or without cause are usually stated specifically in the franchise agreement, alongside a specification as to whether either basis for termination gives the right to immediate termination or the termination is subject to a notice period, which is usually between six and 12 months.

If the franchise agreement does not include a clause regarding termination rights, the franchisee may still terminate the agreement with immediate effect upon a material breach of the contract by the franchisor.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

It varies from chain to chain, but automatic renewal is not customary. It is customary that the renewal is conditional on the franchisee having fulfilled certain formal requirements – such as no breach of the agreement – that the lease agreement for the premises is valid for the renewal period and that the franchisee signs the then applicable chain agreement. Both formal and substantive requirements usually apply.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

There is no legislation or regulation limiting the franchisor's right to refuse the franchisee renewal of the franchise agreement. The fundamental principle of Norwegian contract law is contractual freedom, hence the franchise agreement sets out any limitations. For example, the franchisee may have an option to renew for a certain number of years or periods of years. If there are no such provisions in the franchise agreement, the franchisor may decide to deny or offer the franchisee a renewal at its sole discretion.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

It is common to include a clause in the franchise agreement granting a right for the franchisor to freely approve or veto a transfer of the franchise to a new franchisee. Similarly, change-of-control clauses are common in franchise agreements, usually requiring the consent of the franchisor or granting the franchisor the right to terminate the franchise agreement upon transfer of the voting power in the franchisee.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

No, the parties enjoy full contractual freedom in this regard. Note, however, that the duty of loyalty and good faith – as well as the regulations in the Contract Acts regarding revision or invalidity of contracts owing to

unreasonable terms or fraud – may affect the terms and amounts of the fees and payment obligations.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

There are no legislative restrictions on the amount of interest that can be agreed on overdue payments between professionals. However, the parties must agree on the rate and the principles for calculating the interest rate if they want to use a higher percentage or a calculation principle deviating from the prescribed interest level in the Act Relating to Interest on Overdue Payments, which is at 8 per cent as at June 2021. If the agreed interest is unreasonably high or the basis for calculating the interest is very unfavourable to one party, the court may deem the rate invalid and edit the agreement accordingly. The court very rarely deems an agreement as wholly invalid owing to one clause being found unreasonable and void.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

The parties are free to agree on other currencies than the local one, but unless the parties have made such an agreement and the payments are carried out in Norway, the creditor is entitled to demand payment in the Norwegian kroner.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Generally, yes. Note, however, that in the event of civil proceedings, a contractual confidentiality clause in a franchise agreement is in itself not sufficient to exempt the franchise agreement as evidence unless the documents may be exempted pursuant to legal authority. Hence, the parties will have to submit any relevant documents that they have available and offer witnesses to the court to fulfil their duty of disclosure pursuant to the Dispute Act, irrespective of confidentiality clauses. Regarding confidentiality and trade secrets, the parties may request the courts to not make reference to trade secrets, such as the franchise fee, in the public judgment.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Yes, the general principle of good faith and loyalty applies to all contractual relationships in Norway, including franchise relationships. The principle applies during negotiations and during the whole period of the franchise agreement.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

Franchisees are not considered consumers pursuant to Norwegian law. If a relevant act distinguishes between consumers and professionals, a franchisee is considered a professional. Further, there is generally a presumption that the franchisee is a professional and has the capacity to take on the responsibility of a professional party.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

It is preferable to conduct franchise agreements in Norwegian, but it is not a legislative requirement and, pursuant to the principle of contractual freedom, the parties may agree to use English as their contractual language. Franchise agreements in English are usually supplemented by a presentation of the terms or an unofficial translation of the document in Norwegian stating that the English version takes precedence.

Any disclosure documents to the public authorities should be in Norwegian (eg, corporate documents to be registered in the Register of Business Enterprises), but an additional office translation to English is usually accepted.

Acquisitions, mergers and joint ventures may be notifiable to the Norwegian Competition Authorities. Concentrations that are unlikely to affect competition in the affected market may be submitted through a 'simplified notification', in which case the notification can be written in English. If the conditions for the simplified procedure are not met, the notification must be written in Norwegian.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

The fundamental principle of Norwegian contract law is contractual freedom. Consequently, there are no notable restrictions on specific provisions in relation to franchise contracts. However, competition law holds anticompetitive provisions invalid. We often experience that older franchise agreements include restrictions that are not in compliance with the Competition Law, such as exclusivity clauses, retail price maintenance, restrictions on active sale, the level of purchase obligations of the franchisees and non-compete restrictions after the expiry of the franchise agreement.

Further, the Working Environment Act sets out a specific prohibition against an employer entering into an agreement with other entities, including a non-solicitation of employees clause. However, a non-solicitation of employees clause may nevertheless be entered into in connection with negotiations on the transfer of entities and invoked during the negotiations and for up to six months after such negotiations are terminated. A non-solicitation of employees clause may also be entered into from the date of transfer of the undertakings and invoked for up to six months if the employer has informed all of the affected employees in writing.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The judiciary in Norway is hierarchical, with district courts at the first instance, courts of appeal at the second instance and the Supreme Court as the ultimate court of appeal. The local conciliation boards hear certain types of civil cases based on the value of the dispute and whether both parties have engaged legal counsel. These ordinary courts hear all cases relevant to franchising unless the parties have agreed otherwise or a special authority is competent, such as the Norwegian Competition Authority. As a general rule, all court decisions on civil matters, including commercial matters, are publicly available.

The ordinary courts (except the Supreme Court) offer and advocate either out-of-court or judicial mediation. However, mediation is not compulsory for matters relevant to franchising. If the parties agree to mediation, it is solely up to the parties to reach a solution and the mediator holds no authority to settle the dispute.

Further, the parties may agree to solve potential disputes by arbitration, which may be chosen for commercial disputes as the parties can agree that the solution will be subject to confidentiality.

Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

The Norwegian rules on choice of law are mainly developed through case law and are not laid down in legislation. This makes them somewhat inaccessible. Case law has lately moved towards a more objective and clearer criterion for choosing the governing law for contracts based mainly on the EU rules in the Rome I and Rome II Regulations, which are given great importance in Norwegian case law. For franchise agreements, the Rome I Regulation usually provides a sound starting point when assessing choice of law questions under Norwegian law.

The parties in franchise contracts are free to agree that the contract is governed by foreign law. They are also free to agree that only parts of the contract are governed by foreign law. Any such choice of law clause must preferably be expressly written into the contract, although the courts in certain cases can find a basis for interpreting a choice of law clause by considering the circumstances as a whole. This is in line with article 3 of the Rome I Regulation.

There are certain limitations on this freedom, partly deriving from Norwegian private international law and partly from other rules.

If both the parties to the franchise contract are Norwegian, a choice of law clause designating foreign governing law is construed as incorporating the foreign law into the contract as a part of the clauses in the contract. In such cases, Norwegian mandatory rules apply to the contract, including rules on interpretation and validity.

If one of the parties to the contract is not Norwegian, a choice of law clause designating foreign governing law places the contract in its entirety, including questions regarding interpretation and validity, under the designated governing law. If a dispute arises out of such a franchise contract and the dispute is brought before Norwegian courts, the courts apply the designated foreign governing law. However, it usually falls on the parties to provide objective and adequate legal sources on the foreign governing law, including depositions from legal experts if needed.

Norwegian international private law acknowledges the public policy doctrine. If the choice of law clause designates a foreign governing law that will produce results in direct conflict with the general Norwegian sense of justice, the public policy doctrine gives Norwegian courts the authority to decide the question, or sometimes the case as a whole, based on Norwegian law.

If the courts conclude that the parties have agreed on the choice of law clause and that the result following from the designated foreign governing law is not in conflict with the public policy doctrine, the courts render their judgment on this basis. The judgment can be enforced by the Norwegian authorities in the same way that other judgments are enforced.

Many franchise agreements contain both a choice of law clause and a clause on arbitration. If the contract contains an arbitration clause, Norwegian courts reject hearing the case. In such cases, the choice of law clause is binding for the arbitration tribunal in line with the above considerations.

If the parties have not agreed on a designated foreign governing law, it follows from article 4 No. 1(e) of the Rome I Regulation that the franchise contract is governed by the law of the state in which the franchisee has his or her habitual residence. This would also be the result according to Norwegian international private law.

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Arbitration – advantages for franchisors

44 | What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

The advantages of arbitration are in general the same for foreign and domestic franchisors, that is, the possibility of agreeing on privacy and confidentiality, flexibility for the parties involved, influence on the appointment of an arbitrator, and the efficiency of the process. Furthermore, when the parties agree to settle a dispute through arbitration, they avoid ordinary court proceedings, although the arbitration decision still has effect as a legally enforceable judgment that can be enforced by means of the general legal enforcement procedure in Norway.

The Arbitration Act of 2004 sets out the applicable provisions for Norwegian arbitration and has a special provision stating that foreign arbitration awards can be recognised and enforced in Norway. In many aspects, it is based on the United Nations Commission on International Trade Law's 1985 Model Law on International Commercial Arbitration.

Norway is a party to the United Nations Convention of 10 June 1958 on the recognition and enforcement of foreign arbitration decisions (the New York Convention). The convention is acceded to by about 125 countries, including the countries with which Norway has the most trade. This implies that foreign arbitration decisions can be enforced in Norway without instituting special legal proceedings in the Norwegian courts.

There are no disadvantages specific to foreign franchisors compared with domestic ones. As for arbitration in general, the cost is considerably higher than legal proceedings in the ordinary courts, but most important are the restrictions on appealing against the judgment. An arbitration award may only be brought before the ordinary courts based on annulment actions.

National treatment

45 | In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Pursuant to Norwegian law, there is no legal distinction of whether a franchisor is domestic or foreign.

UPDATE AND TRENDS

Legal and other current developments

46 Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

The Trade Secrets Act, incorporating Directive (EU) 2016/943, entered into force on 1 January 2021. The Trade Secrets Act applies to any kind of secret information of commercial value in a business and is relevant for a franchisee who is considering terminating a franchise contract to engage with a different franchisor or starting a business of its own. According to the Trade Secrets Act, achieving, utilising or spreading a trade secret is prohibited. Note, however, that general knowledge and know-how are not considered to be trade secrets.

* *The information contained in this chapter is accurate as at 14 May 2021.*

South Africa

Dina Biagio and Jeremy Speres

Spoor & Fisher

MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

The Franchising Association of South Africa (FASA), the organisation that promotes and supports franchising in South Africa, compiles a list of accredited franchise businesses, which are franchise businesses recognised, assessed, reviewed and monitored by FASA. Based on this list of accredited businesses, it appears that franchise businesses are found across 21 different business sectors in South Africa, including the agricultural, mining, manufacturing and industrial services, office buildings, home services, fast food and restaurants, health, beauty and body culture, and the retail and direct marketing services sectors.

It appears that franchising is most common in the fast food and restaurants sector as well as retail and direct marketing, with more than 30 franchise businesses active in each of these sectors in South Africa.

Franchising is considered an area for potential growth in the South African economic sphere, as well as in Africa as a whole.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

FASA was established in 1979 to protect, lobby, promote and develop ethical franchising practices in South Africa.

FASA established a Code of Ethics and Business Practices, with which members agree to comply. Several principles of this code were adopted into the Consumer Protection Act No. 68 of 2008. This code compels franchisors to provide a prospective franchisee with:

- a disclosure document, containing all the relevant information about the company and the franchise opportunity;
- a fair and equitable franchise agreement; and
- an operations manual, containing policies and procedures for operating a successful franchise business.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

A franchisor would typically operate via a public or private for-profit company incorporated in terms of the provisions of the Companies Act, No. 71 of 2008 (the Companies Act).

For foreign franchisors, an external or branch company could be established as a wholly owned subsidiary of the foreign parent entity. Foreign franchisors may opt for a joint venture arrangement with a local South African entity as a means to more effectively establish a presence in South Africa. Alternatively, a foreign franchisor may choose to grant rights to a local party (a master franchisee) enabling them to adopt the role of franchisor in South Africa and extend franchise opportunities to sub-franchisees.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

The Companies Act governs the formation and functioning of companies in South Africa.

The Companies and Intellectual Property Commission (CIPC) is tasked with, among other functions, the registration of companies and the monitoring of compliance with the formalities required under the Companies Act.

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

The Companies Act sought to significantly streamline and simplify the formal process of establishing a company in South Africa. New companies can be registered in South Africa relatively easily and cheaply.

At least one director is required for a new company, and that individual's identity document or passport, together with proof of his or her residential address must be provided.

A standard form memorandum of incorporation may be used to set up the company.

There are certain ongoing requirements for maintaining a business entity as prescribed by the Companies Act and the Regulations published thereunder, for example, the requirement that a company must lodge an annual return with the CIPC.

Restrictions on foreign investors

6 What restrictions apply to foreign business entities and foreign investment?

There are very few restrictions on foreign business entities and foreign investment in South Africa. Foreign individuals and entities may acquire property, including immovable property, in South Africa without restriction.

Certain circumstances, like the payment of royalties to a foreign entity, and the movement of capital, intellectual property and other significant assets out of South Africa, may trigger the requirement for exchange control approvals from the South African Reserve Bank. Otherwise, foreigners may trade in South Africa without restrictions or additional requirements to what may be required of a South African citizen.

Taxation

7 What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

The following tax rates apply in South Africa.

- Corporate tax rate: 28 per cent (not applicable to small businesses with less than 550,001 rand in annual taxable income).
- Foreign resident companies that earn income from a source in South Africa: 33 per cent.
- Individuals: taxed at varying rates between 18 per cent and 45 per cent depending on income.
- Standard withholding tax on royalties payable out of South Africa: 15 per cent (in the absence of any taxation treaties).

Labour and employment

8 Are there any relevant labour and employment considerations for typical franchisors?

South African labour laws provide quite significant protections to employees via the Labour Relations Act No. 66 of 1995 and the Basic Conditions of Employment Act No. 75 of 1997.

Whether a franchisee could be deemed an employee of the franchisor would depend largely on the measure of control the franchisor exerts.

Under South African law, a distinction is drawn between employees and independent contractors, where, generally speaking, an employer would have more specific control over the day-to-day activities of an employee and how, when and where the employee's tasks should be completed. An employer generally exerts more control over an employee in terms of how an employee executes required tasks.

To reduce the risk of a franchisee being considered an employee of the franchisor, or the employees of a franchisee being considered employees of the franchisor, provisions should be included in the franchise agreement where the parties confirm the nature of these relationships, and specifically that the franchise agreement does not create an employer–employee relationship. However, it is important to note that should the question of the nature of these relationships be considered, a court would, in addition to any contractual arrangements, consider the factual position surrounding the relationships. These positions would bolster an argument for the absence of an employer–employee relationship, but would not automatically confirm such a position.

Intellectual property

9 How are trademarks and other intellectual property and know-how protected?

Registered and unregistered trademarks are protected in South Africa – the former in terms of the Trade Marks Act No. 194 of 1993 and the latter in terms of the common law.

The CIPC administers the Trade Marks Register in South Africa. Applicants seeking trademark registration must submit separate applications for each trademarked class of goods or services within which they would like their mark to be protected. Once registered, a trademark holder is issued a trademark registration certificate. Trademarks are valid for a period of 10 years, during which period the trademark holder has exclusive rights to use the relevant mark, subject to any conditions that may be imposed by the CIPC. Trademark registrations may be renewed after every 10-year period, for a further period of 10 years, and effectively a trademark holder could protect its rights indefinitely.

Know-how is protected under the common law, with further protections possible under contractual terms.

Real estate

10 What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

There are no real estate laws specific to franchise arrangements.

It is likely that franchise business would be conducted from leased premises with lease rights secured via a lease agreement. General contract laws govern the contractual relationship.

The franchisee is more likely to be the lessee in lease arrangements for leased premises from which a franchise business may be conducted, particularly in relation to franchise agreements where the franchisor is foreign.

The franchisor should prioritise leases as part of its due diligence investigation and, if possible, should ensure that the franchise agreement allows for the lease agreement to be assigned to the franchisor without the landlord's consent.

Competition law

11 What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

The Competition Act No. 89 of 1998 (the Competition Act) applies to franchise agreements as they constitute an economic activity within or having an effect within the country.

In particular, sections of 4(1) and 5(1) of the Competition Act prohibit agreements between firms in a horizontal relationship, or a vertical relationship if it has the effect of substantially lessening or preventing competition in a market unless there is a technological, efficiency or another pro-competitive gain that results from it and outweighs that effect.

The Competition Act contains the so-called rule of reason prohibitions and the so-called per se prohibitions. The rule of reason prohibitions may be justified (ie, where the technological, efficiency or another pro-competitive gain that results from it outweighs any negative effect) whereas the per se prohibitions cannot be justified. Per se prohibitions for firms in a horizontal relationship constitute price fixing, market division (by allocating customers, suppliers territories or specific types of goods and services) and collusive tendering. Minimum resale price maintenance is a per se prohibition for firms in a vertical relationship.

A franchisor is however able to recommend a minimum resale price for a product provided it is not binding on the franchisee and that, if the price is stated on the product, the words 'recommended price' appear next to the stated price. Franchisees cannot be prevented by franchisors from offering discounts to customers at the franchisees' discretion.

An arrangement involving exclusive territories between a franchisor and a franchisee (a vertical relationship) could also be held to be anticompetitive if it cannot be justified by efficiencies in distribution or

other pro-competitive effects (eg, inter-brand competition, where the franchise is more competitive with other franchises).

Section 8 of the Competition Act contains provisions for preventing the abuse of a dominant position by, for example, preventing excessive pricing to the detriment of consumers, refusing to give competitors access to an essential facility when it is economically feasible to do so and engaging in any of the above exclusionary acts.

In the application of competition law and policy, there is little differentiation between franchising agreements and other distribution channels. Although franchise arrangements are based on the licensing of intellectual property rights (which are exclusionary by nature), franchise arrangements are not exempt from competition law. Franchising is therefore seen as an economic activity over which the Competition Act applies.

A proprietor of an intellectual property right seeking to enforce that right in contravention of the Competition Act must seek exemption from the Competition Commission, which considers each matter on its merits under the rule of reason. The use of intellectual property rights can lead to enhanced efficiencies, encourage investment and promote inter-brand competition, making an exemption probable.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

There is no specific legal definition of a franchise under South Africa law.

However, the Consumer Protection Act No. 68 of 2008 (CPA) defines a franchise agreement as follows:

> *[A]n agreement between two parties, being the franchisor and franchisee, respectively -*
>
> *(a) in which, for consideration paid, by the franchisee to the franchisor, the franchisor grants the franchisee the right to carry on business within all or a specific part of the Republic under a system or marketing plan substantially determined or controlled by the franchisor or an associate of the franchisor;*
>
> *(b) under the operation of the business of the franchisee will be substantially or materially associated with advertising schemes or programmes or one or more trade marks, commercial symbols or logos or any similar marketing, branding, labelling or devices, or any combination of such schemes, programmes or devices, that are conducted, owned, used or licensed by the franchisor or an associate of the franchisor; and*
>
> *(c) that governs the business relationship between the franchisor and the franchisee, including the relationship between them with respect to the goods and services to be supplied to the franchisee by or at the direction of the franchisor or an associate of the franchisor[.]*

The Franchising Association of South Africa (FASA) loosely defines franchising as the granting of a right to operate a business or licence under certain specific conditions.

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

The CPA and the Regulations published thereunder, together with the common law, regulates the offer and sale of franchises in South Africa.

The National Consumer Commission is the government agency tasked with the regulation of relationships between consumers and businesses in South Africa. Franchisees are, in certain respects, considered consumers pursuant to the definition of a consumer set out in the CPA.

Principal requirements

14 | What are the principal requirements governing the offer and sale of franchises under the relevant laws?

Section 7(1) of the CPA sets out certain requirements for franchise agreements, which must:

- be in writing and signed by or on behalf of the franchisee;
- include any prescribed information, or address any prescribed categories of information; and
- be in plain and understandable language.

Regulation 2 of the Regulations to the CPA contains further information that must be contained in a franchise agreement as prescribed by the responsible cabinet minister, including information such as the name and description of the relevant goods and services, the consideration payable by the franchisee under the agreement, and renewal terms.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

No, there are no such eligibility laws.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

No, there are no such laws.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

Generally speaking, parties are not required to make any pre-contractual disclosures in South Africa, save for certain specific types of agreements such as insurance, partnership or agency agreements, wherein parties are required to act in the utmost good faith and therefore to disclose any information that may be considered material for the other party in entering into the agreement.

Specific disclosures are required for franchise agreements in the terms of Regulation 3 to the CPA, including:

- the goods or services to which the franchise applies;
- any territorial restrictions that apply;
- the renewal terms for the agreement;
- the specific obligations of, and restraints on, each party; and

- the details of all the financial contributions that will be required of the franchisee.

There is no requirement that this disclosure document should be updated at any point.

Pre-contractual disclosure – content

18 What information is the disclosure document required or advised to contain?

The disclosure document must contain the information stipulated by Regulation 3 to the CPA, including:

- the goods or services to which the franchise applies;
- any territorial restrictions that apply;
- the renewal terms for the agreement;
- the specific obligations of, and restraints on, each party; and
- the details of all the financial contributions that will be required of the franchisee.

FASA makes a disclosure document available on its website, which includes the information referred to above, as well as various other recommendations for information to be provided. This aims to assist a potential franchisee in evaluating the franchised business.

Pre-sale disclosure to sub-franchisees

19 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

The CPA does not directly address this issue. The sub-franchisor would have the direct contractual nexus with the sub-franchisees and, therefore, it is reasonable to argue that the obligation would fall on the sub-franchisor. It is recommended that the master franchisor include a provision in the master agreement obliging the sub-franchisor to fulfil the disclosure obligations and to indemnify the master franchisee if it fails to meet the disclosure obligations.

Due diligence

20 What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

A franchisor should conduct at least basic due diligence into the party or parties wishing to become a franchisee. In the case of individuals, a credit check and criminal check are relatively easy and inexpensive to do. The individual directors of potential franchisee companies could be similarly investigated.

Potential franchisee companies should be asked about details of directors and shareholders, and to share company documents including financial statements. A major potential drawback is that franchisee companies are likely to be new companies set up for the particular purpose of operating the franchisee business. It is, therefore, important to look at the individuals involved and any other businesses or companies with which they may be involved.

Franchisees could verify and evaluate the intellectual property rights that form the subject of the licence granted in the franchise arrangement. Franchisees can also, more generally:

- contact existing franchisees, suppliers, employees and customers;
- study the disclosure documents and financial statements carefully in conjunction with professional advisers to check on financial health and forecasted profitability;
- check whether the franchisor is a member of any industry bodies with enforceable codes of conduct;
- check for any court judgments or poor credit records against the franchise;
- visit franchised stores with a view to experiencing the goods or services from the perspective of a consumer;
- consider the broader market and how competitive it is; and
- consider the regulations and potentially forthcoming regulations that may affect the industry.

Failure to disclose – enforcement and remedies

21 What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

The prospective franchisee can report a failure to issue such notice or particular violations of disclosure requirements to the National Consumer Commission. A person failing to comply would first be issued a compliance notice. It is not clear whether a franchise arrangement would be void or voidable as a result of a failure to supply a disclosure notice.

If the franchisor is a member of FASA, their failure to disclose can be reported to FASA. Although not a government agency, FASA's Code of Ethics and Business Practices provides for the payment of a fine of up to 10,000 rand or termination of membership of the association if members contravene the CPA.

Where a franchisor has omitted certain information or provided incorrect or false information, the franchisee could pursue delictual remedies. To this end, the franchisee would need to prove the damage it suffered as a result of the franchisor's failure to supply the required or correct information.

Failure to disclose – apportionment of liability

22 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

This issue is not specifically addressed in the relevant sections of the CPA.

Liability of this nature should be specifically addressed in the franchise agreement, failing which the ordinarily delictual remedies will apply.

General legal principles and codes of conduct

23 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

The offer of a franchise is regulated by the CPA and its Regulations. Regulation 3 sets out all the information that must be contained in the franchisor's pre-sale disclosure and the documentation that must accompany such a disclosure, including:

- the goods or services to which the franchise applies;
- any territorial restrictions that apply;
- the renewal terms for the agreement;
- the specific obligations of, and restraints on, each party; and
- the details of all the financial contributions that will be required of the franchisee.

South African law does not specifically recognise the doctrine of *culpa in contrahendo*. Furthermore, there is no legally recognised general duty of good faith in contracts.

FASA has a Code of Ethics and Business Practices that sets out the manner in which it expects members to establish, structure and implement franchise relationships.

Fraudulent sale

24 | What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

In this instance, franchisees would be entitled to sue in delict for fraudulent misrepresentation.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 | What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

Section 48 of the Consumer Protection Act No. 68 of 2008 (CPA) provides that the terms of the franchise agreement must not be unfair, unreasonable or unjust.

Regulation 2 of the Regulations to the CPA contains further information that must be contained in a franchise agreement as prescribed by the Minister, including information such as the name and description of the relevant goods and services, the consideration payable by the franchisee under the agreement, and renewal terms.

Operational compliance

26 | What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

Franchise agreements often incorporate provisions granting the franchisor rights of inspection and the ability to audit the franchisee in relation to compliance with certain operational standards or requirements. Reporting requirements are often provided for in the most detail in franchise agreements as this gives the franchisor the most insight into the commercial health and success of the franchise business as run by the franchisee. Reporting provisions are also the most useful rights, particularly for foreign franchisors who may have less opportunity to conduct audits and physical inspections.

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

In terms of the provisions of Regulation 44 (3)(h) and (i) of the CPA, any provisions of a franchise agreement purporting to allow the franchisor to increase the prices of any goods or services without giving the franchisee the right to terminate, or enabling the franchisor to unilaterally alter the terms of the agreement (including the characteristics of the product or service) would be presumed not to be fair and reasonable. Accordingly, such provisions would be prohibited under the CPA.

Policy affecting franchise relations

28 | Do other government or trade association policies affect the franchise relationship?

No, there are no such policies. Membership of the Franchising Association of South Africa (FASA) is voluntary.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

A franchise agreement may only contain a provision for the franchisor to terminate such agreement at will where the same right is afforded to the franchisee.

A franchisor may further only terminate an open-ended franchise agreement on reasonable notice to the franchisee, save where the franchisee has materially breached the franchise agreement.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

In terms of section 7(2) of the CPA, a franchisee may cancel a franchise agreement within 10 business days of signing the agreement, by written notice to the franchisor but without any cost or penalty to the franchisee.

The exact text of section 7(2) must appear at the top of the first page of the franchise agreement, together with a reference to the section and the CPA.

If a franchise agreement contains a provision allowing a franchisor to terminate the franchise agreement at will, then the same right must be afforded to the franchisee.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

Formal or substantive requirements are governed by the terms of the relevant provisions of the franchise agreement.

In terms of the Regulations to the CPA, if a franchise agreement contemplates renewal, both the franchisor and the franchisee must be able to renew the agreement.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

If a franchise agreement does not contain any renewal provisions with which the franchisor is obliged to comply, then there is no specific obligation on the franchisee to renew. Franchisors typically consider the franchisee's business performance during the initial term to determine whether or not to renew.

A franchisor may also refuse to renew a franchise agreement where there has been a material breach of the agreement by the franchisee.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes, a franchisor may impose these restrictions.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

Other than exchange control laws, there are no specific laws or regulations affecting the nature, amount or payment of fees.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

In terms of the Prescribed Rate of Interest Act, the interest on debts where no rate is agreed upon is the repurchase agreement rate plus 3.5 per cent per annum. The prescribed rate of interest on debt in South Africa is currently 10.25 per cent. A different rate may be applied by law, trade custom or agreement between the parties.

This prescribed rate of interest applies to all debts outstanding in terms of a franchise agreement unless the parties agree to another interest rate.

The National Credit Act limits the amount of interest that can be charged on unpaid amounts to 2 per cent per month; however, this only applies where the National Credit Act applies to the franchise agreement. It is unlikely to apply in many instances given that a requirement is that the franchisee would either need to be an individual or a juridical person with an annual turnover of less than 1 million rand per annum.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

Exchange control approvals from the South African Reserve Bank (SARB) are required where royalties are to be paid to a foreign entity. The Department of Trade and Industry (DTI) acting on behalf of SARB must grant approval for any arrangement, including a franchise arrangement, in which products are manufactured locally under licence from a foreign licensor. The DTI has provided guidelines regarding licence terms that it deems to be acceptable and unacceptable, particularly relating to the structure of the licence fee payable and the quantum of any licence royalties payable.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Yes, confidentiality covenants are generally enforceable.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Good faith is recognised as an underlying concept of South African contract law.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

Yes, in terms of the definition of consumer under the CPA, a franchisee is included as a consumer.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

There is no specific statutory requirement that these documents or agreements need to be in any particular South African language. However, FASA does require that disclosure documents and supporting documents should be in English.

South Africa has 11 official languages, with English, Afrikaans, Zulu and Xhosa being the most widely used. English is considered standard for use in business communication and legal agreements.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

Particular restrictions are specific to the requirements of the franchisor and the concerns they may have for the protection of their brand. Territorial restrictions are particularly common and foreign franchisors often want to provide that the governing law of the franchisor's country of origin would apply.

Certain restrictions are legally prohibited, such as restrictions related to the minimum prices that franchisees can charge to their customers. While franchisors can issue a recommended retail selling price, prescribing a particular minimum sales price is prohibited under South African competition laws.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The judicial system in South Africa is established in the Constitution of the Republic of South Africa, 1996 (the Constitution) as follows:

- the Constitutional Court is the highest court in the land as regards constitutional matters;
- the Supreme Court of Appeal (SCA) is the highest court in the land for all matters other than constitutional matters: as the name implies, this court deals exclusively with appeals, where a bench of three to five senior and experienced judges decide on matters;
- a number of High Courts have jurisdiction throughout the various provinces in South Africa, dealing with serious criminal offences and civil matters: there are also a number of specialist High Courts – in this regard the Labour Court, the Tax Court and the Competition Court may be relevant and of interest to a franchisor in South Africa; and
- there are various lower courts, known as magistrates' courts (regional and district), which are mandated to hear matters involving claims of up to 200,000 rand.

Parties to a franchise agreement may choose to include mediation and arbitration proceedings as options for dispute resolution.

Mediation may be less formal and would essentially be a continued negotiation between the parties overseen by an independent third party with relevant experience, as agreed between the parties.

Arbitration is a more formal and adversarial process than mediation.

Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

In the matter of *Foize Africa v Foize Beheer and others* 2013 (3) SA 91 (SCA), it was held that although parties can agree to the governing law and jurisdiction of a particular country with respect to an agreement, this does not exclude the South African courts' jurisdiction. South African courts still hold the discretion to exercise, or refrain from exercising, jurisdiction in a matter where there is a jurisdictional link to the South African courts.

In the event that the governing law in respect of an agreement is foreign and the agreement is subject to South African jurisdiction, South African courts would give effect to the choice of law exercised by the parties. However, this would not exclude the application of relevant South African statutes (eg, the CPA).

Arbitration – advantages for franchisors

44 | What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

The main advantages of the settlement of disputes via arbitration proceedings in South Africa include:

- that parties are free to choose (and include in any relevant contract) the particular rules that will be applicable to and govern any arbitration;
- that arbitration proceedings are generally shorter, or have a known time frame for their conclusion, or both;
- that an appointed arbitrator to a dispute will have specialist knowledge and skill relevant to the dispute;
- that arbitration proceedings offer a more private, closed forum, which is particularly important where sensitive commercial information is to be dealt with;
- that, in some instances, arbitration is likely to be less costly than litigation proceedings, or at least the costs can be estimated ahead of time (because time frames for arbitrations are often more circumscribed); and
- that, in international disputes, there may be a perceived sense of neutrality given that both parties have chosen the particular forum and rules and parameters that apply (as opposed to the authority of a court of local jurisdiction of one of the parties).

The primary disadvantages include that, in some instances, arbitration could be a more expensive avenue. Where third parties become embroiled in a dispute, these relevant parties must consent to participate in arbitration proceedings as they cannot simply be joined in a matter as they would in court proceedings.

National treatment

45 | In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Except for the effect of the exchange control regulations, foreign and domestic franchisors are not treated differently in any respect, legally or otherwise.

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UPDATE AND TRENDS

Legal and other current developments

46 | Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

From a legislative and regulatory perspective, there are no new developments on the horizon in the franchising space.

The Franchise Association of South Africa predicts that franchising in education will become popular, spurred on by the online schooling required during covid-19 lockdown measures. Vendors of meat-free food products and green technologies are also expected to gain support. The use of data analytics and artificial intelligence to identify customer buying patterns and improve business efficiencies are highlighted as trends. The importance of having an online presence and making use of social media marketing remains in the spotlight.

South Korea

Sun Chang
Lee & Ko

MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Franchising is widespread in Korea and is growing every year. According to statistical data provided by the Korea Fair Trade Commission (KFTC), in 2021, there were about 11,218 registered concepts owned by 7,342 franchisors and operated at 270,485 franchised units. The KFTC perceives that the 58.1 per cent increase in the number of brands was due to a recent amendment to the Franchise Act, which now imposes the obligation to register franchise disclosure documents on small-scale franchisors, and requires any franchisors who intend to register franchise disclosure documents to have at least one year of experience in operating at least one or more directly managed units by that franchisor. Meanwhile, franchising is most prevalent in the food services industry, followed by the service (eg, language education), wholesale and retail industries (eg, convenience stores, cosmetics).

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The Korea Franchise Association (KFA) is a non-profit organisation licensed by the Ministry of Trade, Industry and Energy. Its role is to promote the sound development of the franchise industry, mutual growth between franchisors and franchisees, and assist the globalisation of national brands. A franchisor that has registered its disclosure document with the KFTC can join as a member of the KFA and must abide by the KFA's rules of ethical conduct.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

The stock company and the limited liability company are the business forms in Korea that would be relevant to a typical franchisor. About 90 per cent of Korean companies are stock companies, which are similar to US stock companies. Only this legal entity, plus occasionally the limited liability company, is recommended for foreign investors and businesses.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

Primarily, the Korean Civil Act and Korean Commercial Code govern the formation of business entities. In addition, the Foreign Investment Promotion Act relates to the formation of business entities from foreign investment.

The Korean Court Commercial Registrar, the National Tax Service, and the Ministry of Trade, Industry and Energy are the main agencies that have authority related to the formation of business entities in Korea.

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

There is no minimum paid-up capital for a stock company or a limited liability company. Registration is with the Court Commercial Registrar and National Tax Service. In the case of investment by foreign business entities or foreigners, the investment must be reported to the Ministry of Trade, Industry and Energy (in practice, the function of receiving reports is delegated to designated foreign exchange banks or the Korea Trade-Investment Promotion Agency).

Restrictions on foreign investors

6 What restrictions apply to foreign business entities and foreign investment?

A foreigner may freely carry on foreign investment activities in Korea without being subject to any restrictions unless otherwise specifically restricted by the Foreign Investment Promotion Act or other laws or regulations.

Specifically, a foreigner does not face any restrictions in investing in Korea other than in the following circumstances:

- where it interferes with national security or disrupts public order;
- where it causes harm to the health and safety of nationals or is markedly contrary to public morals and decency; or
- when it violates Korean laws and regulations.

Taxation

7 What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

The principal taxes affecting business enterprises in South Korea include corporate tax, individual income tax, value added tax, customs duty and inhabitant tax levied on corporate tax, income tax and other taxes.

The franchisor has a duty to pay taxes (corporate tax or individual income tax) on royalty income. However, the tax rates are limited to the rates stipulated in the tax treaty between Korea and the state in which

the franchisor resides. Meanwhile, the franchisee has a duty to withhold taxes from royalties it pays to the franchisor.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

Under the Korean Civil Code, an employer is liable for a tort committed against a third party by an employee who is under the employer's actual direction or supervision, in relation to the performance of a work that is directed or supervised by the employer. Therefore, if a franchisee or its employee is deemed to be an employee of the franchisor, the franchisor may be held liable for damages to a third party caused by the franchisee or the franchisee's employee during the performance of his or her work.

To reduce the risk of such liability, it is advisable for the franchisor not to be involved with the specifics of the franchisee's management and to specify in the franchise agreement that the franchise will be operated by the franchisee as an entity independent from the franchisor. However, since a franchisor and a franchisee are generally independent entities, and therefore the franchisee is not subject to the direction or supervision of the franchisor, it is unlikely that the above liability would be imposed on the franchisor.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

Korea is a first-to-file jurisdiction. To obtain reliable protection of trademark rights in Korea, the owner of the trademark should register it with the Korean Intellectual Property Office pursuant to the Trademark Act. During the application period, no protection is provided. However, while the application is pending, the applicant may send a warning letter to any person who uses an identical or similar mark on goods that are identical or similar to the goods for which the application has been filed. If the trademark application subsequently becomes registered, the applicant (now the registrant) may bring a claim against such person for losses accrued from the date the written warning was received by such person up to the registration date of the trademark.

Once the registration is granted, the owner may seek to enforce the trademark rights against third-party infringements by seeking injunctive relief against further infringement, damages or an order for the destruction of the infringing goods.

In addition to the Trademark Act, the Unfair Competition Prevention and Trade Secret Protection Act is available to protect well-known but unregistered trademarks, trade secrets and know-how.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

In the past, the ownership of Korean real estate by foreigners was regulated in two ways: restrictions on title to land under the Alien Land Acquisition Act, and restrictions against leasing real estate (land or building) under the Foreign Investment and Foreign Capital Inducement Act. However, the Alien Land Acquisition Act was substantially amended in 1998 to permit a foreigner to purchase real property located in Korea with a simple report of the acquisition of title to the relevant local government office (this act has been repealed and reporting is now required under the Act on Report on Real Estate Transactions, Etc). In addition, through amendments to the Foreign Investment and Foreign Capital Inducement Act in 1998, foreign investment in the business of leasing real estate was fully liberalised (the name of this act was changed to the Foreign Investment Promotion Act). In practice, most franchisees lease, rather than own, the real estate in which they operate their franchised units.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

The Monopoly Regulation and Fair Trade Act (MRFTA) is the primary competition statute in Korea. The general provisions of the MRFTA apply to regulate the franchise relationship (eg, establishing resale price maintenance, prohibiting product tying and imposing minimum sales targets).

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

Under the Fair Transactions in Franchise Business Act (the Franchise Act), a franchise is defined as:

> *a continuous business relationship in which the franchisor allows the franchisee to sell goods (including raw and auxiliary materials) or services under certain quality standards and business method using its trademarks, service marks, trade name, signs and other business marks (collectively, 'Business Marks'), and supports, educates and controls the franchisee with regard to relevant management and operating activities, and in which the franchisee pays franchise fees to the franchisor in return for the use of the Business Marks and the support and education concerning the management and operating activities.*

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

The Franchise Act, which was enacted on 1 November 2002 and most recently amended on 18 May 2021, and which came into effect on 19 November 2021, and its Presidential Decree (most recent amendment effective on 19 November 2021), are the primary statutes applicable to the franchisor–franchisee relationship. Additionally, the Commercial Act, the Monopoly Regulation and Fair Trade Act (MRFTA) and regulations promulgated by the Korea Fair Trade Commission (KFTC) are generally applicable.

The Franchise Act provides that the Act will not be applicable if the total franchise fees paid by the franchisee to the franchisor for a six-month period beginning from the date of initial payment of franchise fees do not exceed 1 million won, or if the annual sales of the franchisor is less than 50 million won. However, where the franchisor has established and operated a directly managed outlet before it begins offering the franchise business for at least one year, the inapplicability threshold for franchisor annual sales under the Franchise Act is 200 million won. However, with the recent amendment to the Franchise Act, these small-scale franchisors are now required to abide by articles 6-2 through 6-5, 7, 9, 10, and 15-2 of the Franchise Act, which generally provides obligations regarding registration of franchise disclosure documents, deposit of franchise fees, provision of franchise disclosure documents to prospective franchisees, prohibition on providing false or exaggerated information, return of franchise fees under certain conditions, and indemnity insurance contract for

franchisees. In other words, the scope of exemptions for small-scale franchisors is significantly reduced.

The KFTC regulates franchises in Korea. The KFTC maintains a franchise-specific department, the Korea Fair Trade Mediation Agency, and has the authority to impose administrative measures against franchisors that engage in unfair activities. In this regard, the KFTC has the discretion to determine the unfairness or reasonableness of the activities of the franchisor, levy penalties, and issue corrective orders against violators depending on the nature and degree of the unfair activity. However, the violator may seek a district court's judicial review of the KFTC's findings.

Principal requirements

14 What are the principal requirements governing the offer and sale of franchises under the relevant laws?

The Franchise Act is based on the principle of good faith and fair dealing, and seeks to provide a framework for building a fair and equal business relationship between the parties involved in franchising. The Franchise Act delegates the task of overseeing the Korean franchise industry to the KFTC, and the KFTC in turn provides necessary guidance and order by monitoring and calibrating the industry through corrective measures and penalties for those who violate the Franchise Act.

The Franchise Act is divided into six main chapters.

Chapter I sets the stage by providing the purpose of the Franchise Act and the definitions of various terms used throughout the Franchise Act. Chapter II deals with the basic principles that govern franchise transactions and Chapter III addresses fairness in franchise transactions, which, among other requirements, places registration and disclosure obligations on the franchisor.

Chapter III provides a list of basic, mandatory provisions that need to be included in a franchise agreement. Chapter IV outlines the dispute mediation committee regulated by the KFTC and details the qualifications and the roles of the committee. Chapter IV also defines the roles and responsibilities of 'franchise brokers.'

Chapter V deals with the disposition of cases under the KFTC and stipulates details of the corrective measures that can be instituted, including a provision on administrative fines imposed on a franchisor that violates certain provisions of the Franchise Act. Furthermore, because this chapter makes references to provisions of the MRFTA, a franchisor must also be concerned with the application of the MRFTA. Chapter VI imposes administrative and criminal liabilities and, depending on the nature and degree of the violation, a maximum prison sentence of up to five years or a penalty of not more than 300 million won could be imposed.

Franchisor eligibility

15 Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

Franchisors who intend to register a disclosure document (ie, companies that intend to start a franchise business) must have at least one year of experience in operating at least one directly managed unit by that franchisor. An affiliate's experience will not be sufficient to satisfy this requirement. However, the Franchise Act provides exceptions for franchisors who operate franchised business with permission or licence under relevant laws and regulations, franchisors who have at least one year of experience in operating a business in the same industry as the franchised business in or out of Korea, and franchisors whose businesses have been verified by KFTC even if they have no experience in operating directly managed units.

Franchisee and supplier selection

16 Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

The Franchise Act requires a franchisor to expressly grant a franchisee an exclusive business territory in the franchise agreement. Specifically, the franchisor must define the business territory pursuant to an agreed-upon criterion (eg, geographic scope) and stipulate the business territory in the franchise agreement. During the term of the franchise agreement, the franchisor cannot establish a company-owned, affiliate-owned or franchised unit of the 'same type of business,' which is determined on a case-by-case basis, within the business territory of the franchisee.

The term 'same type of business' means a business that would be considered the same in light of various factors, including the target class, territorial boundary, population boundary, types of products and services sold, and business manner and method.

Pre-contractual disclosure – procedures and formalities

17 What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

Prior to the amendments to the Franchise Act that occurred in 2007, which came into force in 2008, a franchisor was excused from the obligation to disclose to the prospective franchisees unless the prospective franchisees specifically requested delivery of the disclosure document in writing. However, under the current Franchise Act, a franchisor must make pre-contractual disclosure to enter a franchise relationship. The disclosure procedure is as follows:

- a franchisor must provide a disclosure document even if the franchisee does not specifically request it in writing;
- in providing the disclosure document to a prospective franchisee, a franchisor must register the disclosure document with the KFTC and, thereafter, provide the registered disclosure document to the prospective franchisee; and
- the acceptance of franchise fees or execution of a franchise agreement is prohibited unless the franchisor has provided the registered disclosure document and 14 days (seven days if the prospective franchisee has been advised by counsel or franchise broker) have elapsed from the date of providing the registered disclosure document.

The disclosure document may be delivered to a prospective franchisee by:

- providing the disclosure document (hard copy) directly or sending it by content-certified mail to the prospective franchisee;
- providing the disclosure document via access to the internet; or
- emailing the disclosure document in an electronic file to the prospective franchisee.

Regarding the update of the disclosures, a franchisor must register (or report) any changes in the disclosure document with the KFTC. Depending on the importance of the information that has been changed, deadlines for filing the report thereto range from within 30 days of the occurrence of the cause of the change and within 30 days of the expiration of the quarter in which the cause of the change has occurred. Further, the franchisor has an obligation to update the disclosure document on an annual basis within 120 days of the expiry of each fiscal year.

Pre-contractual disclosure – content

18 What information is the disclosure document required or advised to contain?

The following broad categories of information are required to be included in the disclosure document:

- information regarding the general status of the franchisor;
- information regarding the current status of the franchisor's franchise (eg, the total number of company-owned and franchised units in operation as at the end of the most recent fiscal year);
- information regarding any legal violation by the franchisor and its executives;
- information regarding the obligations of the franchisee;
- information regarding conditions of and restrictions on the business activities of the franchisee;
- information regarding detailed procedures and the period required in respect of the commencement of the franchised business;
- information regarding support for business activities, and education and training programmes (it must be specified if there is no plan for education and training);
- information regarding the current status of the franchisor's directly managed stores (eg, duration of operation and sales);
- information regarding any mark-ups (prices set higher than reasonable wholesale price) on mandatory purchase items that the franchisee is required or recommended to buy from the franchisor or its designated suppliers;
- information regarding the high-end price and the low-end price of items that are in the top 50 per cent of the items – the 'major items' – sourced to the franchisee by the franchisor or its designated suppliers; and
- information regarding any compensation or economic benefits received by the franchisor or 'specially related entities' of the franchisor by compelling or recommending the franchisee to transact with a designated counterparty (eg, authorised supplier).

In addition to the information contained in the disclosure document, as separate documents, a franchisor must also provide the following:

- information regarding the projected minimum and maximum sales revenue of the franchised unit for a period of one year after commencing operations, including the distance between the franchised units that served as the basis for calculating the sales projection and the prospective franchisee's contemplated franchised unit; and
- information regarding the 10 closest franchised units (eg, contact information, business name and location of the franchised units).

Pre-sale disclosure to sub-franchisees

19 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

In a sub-franchising structure, the sub-franchisor must make pre-sale disclosures to sub-franchisees. A franchisor – the master franchisor – need not provide a disclosure document to a sub-franchisee if the franchisor is not in a contractual relationship with the sub-franchisee, which is usually the case. In other words, a franchisor has no obligation to provide a disclosure document if it is not a party to the franchise agreement or any other agreements with a sub-franchisee.

In a disclosure document, there must be a disclosure on the description of the general status of the franchisor. Although neither the Franchise Act nor its Presidential Decree specifically requires that the information concerning the master franchisor (and, further, the information on the contractual or other relationship between the master franchisor and the sub-franchisor) be included in the disclosure document as the information relates to the 'description of general status of the franchisor', depending on the circumstances, it could be appropriate to include a brief summary of such information on the sub-franchising structure in the disclosure document.

Due diligence

20 What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

For franchisors seeking to offer their concepts in Korea, it is advisable to carry out due diligence on business considerations (eg, types and composition of products or service offerings, import costs, local costs, payments, market trends and, if relevant, political risks), legal and regulatory matters (eg, the legality of selling or offering certain products or services, the validity of trademarks and other intellectual properties, registration and pre-contractual disclosure, and the franchisee's permits, licences or approvals for carrying out the franchise business) and the prospective franchisee (eg, full registered name and address, organisational structure, financial capability, reputation, involvement in past civil, criminal or administrative proceedings, and actual or threatened court or other legal or criminal actions).

Failure to disclose – enforcement and remedies

21 What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

If there is a violation of any disclosure requirements, the franchisee may report such a violation to the KFTC. Furthermore, the franchisee may bring a lawsuit for damages and cancel or rescind the franchise agreement under general principles of tort or contract law in accordance with the Korean Civil Code. If damages remain that are not recovered by cancelling or rescinding the franchise agreement, the franchisee may additionally be entitled to remaining damages, apart from such cancellation or rescission.

Violations of the Franchise Act may be introduced in a lawsuit for damages as evidence of a party's pattern of conduct or culpability for conduct, but in general such violations do not have any bearing on the calculation of damages in a civil context. Damages are calculated by the general principles of tort and contract law (proximate causation theory), and there is no specific law or regulation applied to franchise transactions. However, if the franchisor has caused any loss to a franchisee by providing false or exaggerated information, by unreasonably suspending or refusing supply of goods, services or assistance, or by imposing retaliatory measures for the franchisee's application for mediation or cooperation with KFTC, the franchisor may be subject to treble damages.

In connection with criminal penalties, the Franchise Act does not create any private right of action. The franchisee can only report the franchisor's violations to the KFTC. A complaint from the KFTC is required to initiate a public criminal proceeding against franchisors, who may have violated the Franchise Act. Upon receiving a report from the franchisee or investigating on its own initiative, the KFTC may decide to institute a public criminal proceeding depending on the seriousness and clarity of the violation of the franchisor. In addition, the prosecutors may, on their own initiative, request the KFTC to file a complaint. In this case, the KFTC must comply with the request. Once there is a public criminal indictment, the KFTC cannot withdraw the complaint.

In theory, criminal penalties under the Franchise Act for disclosure violations are among the most severe in the Korean business sphere. The most severe penalty is reserved for fraud; provision of false or exaggerated information or omission of important items in a disclosure document required under the Franchise Act carries a penalty of up to five years' imprisonment or a fine of not more than 300 million won. Failure to provide a disclosure document, or execution of a franchise agreement or acceptance of franchise fees within the 14 days (seven days if the prospective franchisee has been advised by counsel or franchise broker) after the delivery of the disclosure document is subject to a possible term of imprisonment of up to two years or a fine of up to 50 million won.

Refusal to comply with the KFTC's orders to provide disclosure, if such orders are given, is also potentially subject to a serious penalty. Where disclosure is not provided, or where the disclosure is later reviewed by the KFTC upon the franchisee's request and found to be insufficient (but not fraudulent), the KFTC may demand that the franchisor provide proper disclosure materials. Failure to do so in the face of the KFTC's corrective order may be subject to up to three years' imprisonment or a fine of up to 100 million won.

In addition, in certain cases of disclosure failures, the KFTC may order the return of the franchise fees received.

The KFTC generally prefers to apply pressure to a party – usually the franchisor, given the purpose of the statute – to correct its behaviour to prevent criminal sanctions from being imposed.

Failure to disclose – apportionment of liability

22 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

A master franchisor has no duty to provide a disclosure document if it is not a party to the franchise agreement or any other agreements with a sub-franchisee. In this case, liability for violations of any disclosure requirements is solely attributable to the sub-franchisor.

If individual officers, directors and employees of the franchisor engage in a disclosure violation, they would be exposed to liabilities similar to those of the franchisor. Such individuals may be subject to claims for damages filed by the franchisee or in egregious circumstances may face criminal penalties.

General legal principles and codes of conduct

23 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

The general fair trade principles under the MRFTA may affect the offer and sale of franchises. No other rules or regulations and government agency or industry codes other than those of the KFTC may affect the offer and sale of franchises in Korea.

Fraudulent sale

24 What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

Fraudulent or deceptive practices by a franchisor may constitute fraud as stipulated under the Korean Criminal Code. In the case of a disclosure violation, the franchisee can only report such violation to the KFTC. Thereafter, the KFTC will determine whether to initiate criminal proceedings. In the case of fraudulent or deceptive practices constituting criminal fraud, the franchisee may directly file a criminal complaint with the prosecutors. In addition, the franchisee may file a lawsuit for damages against the franchisor with or without cancelling or rescinding the franchise agreement itself.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The Fair Transactions in Franchise Business Act (the Franchise Act) regulates the ongoing relationship between a franchisor and its franchisee after the franchise agreement comes into effect. Moreover, the general provisions of the Monopoly Regulation and Fair Trade Act (MRFTA) apply to regulate the franchise relationship (eg, establishing resale price maintenance, prohibiting product tying and imposing minimum sales targets).

Operational compliance

26 What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

Generally, the franchisor includes inspection rights (eg, access to the premises of franchised units) and audit rights (eg, review of the accounts, books and records of the franchisee) in the franchise agreements as the primary mechanisms for ensuring operational compliance and standards. Although not as prevalent, some franchisors also reserve the right to deploy mystery shoppers and, to the extent permitted under Korean privacy laws, install video surveillance as part of an overall effort to maintain brand uniformity and operational compliance.

Amendment of operational terms

27 May the franchisor unilaterally change operational terms and standards during the franchise relationship?

A franchisor may not unilaterally change operational terms and standards in a way that may be considered disadvantageous to the franchisee as such conduct could be seen as an unfair trade practice under the Franchise Act and, more generally, under the MRFTA.

Policy affecting franchise relations

28 Do other government or trade association policies affect the franchise relationship?

The guidelines provided by the Korea Fair Trade Commission (KFTC) may affect the franchise relationship.

Termination by franchisor

29 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

The Franchise Act does not specify grounds for terminating a franchise agreement; it merely provides the procedure that must be observed to terminate a franchise relationship.

To terminate a franchise agreement in accordance with the Franchise Act, a franchisor is required to provide a first notice of breach

(which describes the grounds for the breach, requests for a remedy of such breach, and states that failure to remedy will result in termination) to the franchisee. Once the first notice is given, a two-month remedy period begins to run (and the franchisee's obligation to remedy arises). During the remedy period, the franchisor must send a second notice of the same breach to the franchisee. If the franchisee fails to remedy the breach, the franchisor may terminate the franchise agreement at the end of the two-month remedy period.

Meanwhile, the Presidential Decree provides for nine exceptions to the above termination procedure and thereby allows for immediate termination of the franchise agreement by the franchisor. No other grounds for immediate termination are permitted under the Franchise Act. The nine exceptions are:

- a petition for bankruptcy is filed with respect to the franchisee (either by the franchisee or by a third party), the franchisee is adjudicated bankrupt, or rehabilitation or foreclosure proceedings commence against the franchisee;
- a suspension of payment of notes and cheques issued by the franchisee owing to insolvency, etc;
- the franchisee cannot continue with the operation of any franchised unit in the territory owing to an event of force majeure or for significant personal reasons, etc;
- the franchisee receives a court judgment for violation of laws related to the operation of a franchised unit or receives an administrative disposition for violating the applicable laws that clearly damages the reputation and credit of the franchisor and the franchisor has suffered significant harm, including:
    - an administrative order requiring the franchisee to remedy the violation;
    - an administrative order imposing a penalty surcharge or fine on the franchisee for the violation; or
    - an administrative order mandating the suspension of operation of the franchised business;
- the franchisee violates laws or regulations relating to the operation of any franchised unit and receives a cancellation order of qualifications, licences, or approvals or a business suspension order exceeding 15 days or other administrative order that cannot be corrected, provided that this shall not apply where an administrative fine, etc, has been imposed on a franchisee in lieu of such administrative order pursuant to any laws or regulations;
- if, after having remedied the breach of the franchise agreement pursuant to the request from the franchisor, the franchisee subsequently repeats the same breach within a period of one year even if the franchisor has notified the franchisee in the notice requesting a remedy for the first breach that the franchise agreement could be terminated without providing the opportunity to remedy in case of another of the same type of breach after the remedy;
- if the franchisee has been subjected to criminal punishment for an activity relating to the operation of a franchised unit;
- the acts, errors or omissions of the franchisee clearly and imminently threaten public safety or health while operating any franchised unit, and it is difficult for the franchisor to await an administrative order; or
- the franchisee suspends business operations of any franchised unit for seven or more consecutive days without justifiable cause (as determined by the franchisor acting in good faith).

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

Under the Franchise Act, no restriction or prior notice is required for the franchisees to terminate their franchise relationships. As a general principle of law, however, the franchisee may terminate the franchise agreements in the case of default by the franchisor. In addition, where the franchise agreement is seen as a 'continuing contract', the franchisee may terminate the franchise agreement based on the grounds that the purpose of the franchise agreement has been frustrated as a result of unforeseeable circumstances. In this regard, the Commercial Act provides that a party to a franchise agreement may terminate the agreement under unavoidable circumstances by providing a prior notice to the other party within a set reasonable period, regardless of the duration stipulated in the franchise agreement.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

There are no formal (eg, stamp duty, witnesses) or substantive requirements for renewals of franchise agreements.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

The Franchise Act stipulates that if the franchisee requests a renewal between 90 and 180 days prior to the expiry of the franchise agreement, the franchisor may not refuse to renew the franchise agreement without just cause. As exceptions, the franchisor is permitted to refuse renewal of the franchise agreement in the following circumstances:

- the franchisee has failed to perform its payment obligations of franchise fees under the franchise agreement;
- the franchisee has not accepted the terms and conditions of the franchise agreement or business policy that are generally accepted by other franchisees of the franchise network; or
- the franchisee has failed to observe the following important business policies of the franchisor that are deemed necessary for maintaining the franchised business:
    - matters pertaining to the procurement of a store or facility that are necessary for the operation of the franchised business, or acquisition of a licence, permit or approval as required by applicable laws;
    - matters pertaining to the observance of production methods or service methods that are necessary for maintaining the quality of the goods or services for sale; and
    - matters other than those above that are deemed necessary for normal operations of the franchised business as determined by the Presidential Decree to the Franchise Act.

If the franchisee requests a renewal, the notice of refusal stating the reasons for non-renewal must be provided within 15 days of receipt of the renewal request. If the notice of refusal (to the franchisee's request for a renewal) is not provided to the franchisee, or a written notice of non-renewal or change in terms and conditions (for the renewal) is not provided to the franchisee between 90 and 180 days prior to the expiration of the franchise agreement, the franchise agreement will be deemed to have been renewed under the same terms and conditions.

As a cautionary note, even if a franchisee does not request a renewal, a franchisor must provide a written notice of non-renewal of the franchisee (between 90 and 180 days prior to the expiration of the franchise agreement) if the franchisor has no intent or does not wish to renew the franchise agreement. If the franchisor first provided a notice of non-renewal (prior to the franchisee's request for renewal) within the above period, then the franchisee subsequently requests a renewal within the same period (despite the franchisor's notice of non-renewal), the franchisor may not refuse to renew the franchise agreement without just

cause. In other words, the franchisor's notice of non-renewal (before the franchisee has made a request for renewal) would realistically work only as a reminder to the franchisee to decide whether to renew the franchise agreement.

The franchisee's right to request a renewal may only be exercised for a total duration of 10 years (including the term of the initial franchise agreement and any renewal terms thereafter) and if 10 years have elapsed, the franchisor may refuse to renew the franchise agreement regardless of its reasons (as long as written notice of non-renewal has been provided).

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Because it can be said that the franchisor–franchisee relationship is reciprocal, where both parties are creditors as well as debtors to each other (supply obligation on the one hand and payment obligation on the other hand), the franchisee should receive the consent of the franchisor prior to transferring the franchised business (transfer of its obligation) to a third party. In this regard, the Franchise Act provides that the franchisee must first obtain prior written consent of the franchisor to assign the franchised business. Thus, a franchisor may restrict a franchisee's ability to transfer its franchised business. The Commercial Act further elaborates on such restrictions and prevents the franchisor from refusing the assignment unless there are extenuating circumstances.

However, unless the parties have specifically agreed not to allow for the transfer of ownership interests in a franchisee, there are no restrictions on the franchisee's right to transfer ownership interests.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

The payment and receipt of certain types of fees are strictly regulated under the Franchise Act. Specifically, the Franchise Act proscribes a franchisor from receiving direct payment of the following from the franchisee:

- any consideration that the franchisee pays to the franchisor for management rights, such as the permission to use the business marks or the support and education for its operating activities, potentially including:
  - application fees;
  - membership fees;
  - franchise fees;
  - education and training fees; or
  - down payments; and
- any consideration that the franchisee pays to the franchisor to secure payment for goods supplied by the franchisor or compensation for damages.

The Franchise Act stipulates that the franchisor must require the franchisee to deposit – in escrow – the two types of fees described above to a Korean financial institution prescribed by the Presidential Decree to the Franchise Act. Thereafter, the franchisor may request payment from the financial institution at the earlier of when the franchisee has commenced operations (eg, opened its franchised unit) or two months from the date of execution of the franchise agreement.

Notwithstanding the above, the franchisor may receive both types of fees directly from the franchisee without depositing the fees with a Korean financial institution if:

- the franchisor subscribes to an insurance policy (with the franchisee as the beneficiary) to cover the franchisee's risks; or
- the franchisor and the franchisee agree that the franchisor will receive both types of fees after two months from the date of executing the franchise agreement or after the franchisee commences operation (eg, opened its franchised unit), whichever is earlier.

In practice, it is difficult, if not impossible, to find a Korean financial institution that will open an escrow account for the benefit of a foreign franchisor. Further, with regard to taking out insurance, there is only one insurance provider in Korea – the Seoul Guarantee Insurance Company – that will issue an insurance policy. To subscribe, a foreign franchisor must have a guarantor located in Korea (individual or a business entity) that will guarantee the amount of the insurance policy being purchased.

Given the difficulties in finding a willing Korean financial institution and a suitable guarantor in Korea, foreign franchisors seeking to receive the two types of fees described above directly from the franchisees often choose to defer the payment of those fees until two months have elapsed from the date of executing the franchise agreement or the franchisee commences operation of its franchised unit, whichever occurs earlier.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

There are no specific restrictions on the amount of interest that can be charged on overdue payments. However, if the interest is deemed excessive, it can be reduced by the Korean courts if challenged.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There are no laws or regulations restricting the ability of a franchisee to make payments to a foreign franchisor in the franchisor's domestic currency.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

In principle, confidentiality covenants in franchise agreements are enforceable. Also, the Commercial Act provides that a franchisee's confidentiality obligation with respect to the franchisor's trade secrets must survive termination of a franchise agreement.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Apart from the specific rules and regulations applicable to the conduct of a franchisor, the Franchise Act also promulgates a code of best practice. Under the Franchise Act, both parties to a franchise relationship must exercise good faith in the performance of their respective duties in connection with the management and operation of the franchised business.

Specifically, the franchisor's duties defined under the Franchise Act are as follows:

- business planning for the success of the franchised business;
- continuing efforts toward quality control of goods or services and development of sales techniques;
- the installation of unit facilities and supply of goods or services to the franchisee at reasonable prices;

- the education and training of the franchisee and its employees;
- continuing advice and support for the management and operation activities of the franchisee;
- a prohibition against establishing a franchisor's company-owned units or establishing a franchised unit of the same type of business to that of the franchisee's franchised unit within its business territory during the period of the franchise agreement; and
- making efforts to resolve disputes through dialogue and negotiations with the franchisee.

Meanwhile, the franchisee's duties are defined under article 6 of the Franchise Act as follows:

- making efforts to maintain the uniformity of the franchised brand and the good reputation of the franchisor;
- the maintenance of inventory and display of goods in an appropriate manner in accordance with the franchisor's supply plan and consumer demand;
- compliance with appropriate quality standards as presented by the franchisor with regard to goods or services;
- the use of goods and services as provided by the franchisor in the event of failure to stock goods or services that meet the quality standards provided in the preceding point;
- compliance with appropriate standards as presented by the franchisor with regard to the facilities and exterior of the place of business, as well as the means of transport;
- consultation with the franchisor prior to effecting any changes in the goods or services in which it deals or in its operating activities;
- the maintenance and provision of the data necessary for unified business management and sales strategy formulation by the franchisor, including, but not limited to, accounting books on the purchase and sale of goods and services;
- the provision to the officers, employees or agents of the franchisor of access to its place of business for the checking and recording of its business status and the data as set out in the preceding point;
- a prohibition of any change in the location of its place of business or any transfer of franchise management rights without the consent of the franchisor;
- a prohibition of any act engaging in the same line of business as that of franchisor during the period of the franchise agreement;
- a prohibition of the disclosure of sales techniques or trade secrets belonging to the franchisor; and
- notification of any infringement of business marks by a third party to the franchisor if it becomes aware of such infringement, and appropriate cooperation with the franchisor to take necessary measures to prohibit such infringement.

The Franchise Act provides neither criminal penalties nor sanctions for failing to adhere to the above duties applicable to the franchisor and the franchisee. Therefore, we interpret most of these provisions as normative or suggested best practice rather than as mandatory standards.

Some Korean franchise agreements explicitly stipulate that a franchisor and a franchisee shall perform their duties in good faith. Even if there is no explicit provision in the franchise agreement that mandates good faith dealing, however, the implied covenant of good faith and fair dealing under the Korean Civil Act apply to the franchise relationship.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

In principle, franchisees are deemed to be independent commercial entities, and therefore there are no laws that specifically treat franchisees as consumers for the purposes of consumer protection.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

Under the Franchise Act, there are no requirements that the disclosure documents be prepared in Korean. However, because the Franchise Act prescribes that the disclosure documents (that will be provided to the prospective franchisee) be registered with the KFTC, in practice the KFTC requires the disclosure documents to be prepared in Korean.

The Franchise Act does not require that the franchise agreement be written in Korean either. However, it is advisable for foreign franchisors to critically evaluate the English language capabilities of any prospective franchisees and be prepared to offer a Korean translation of franchise agreement if the franchisee does not comprehend English or is not using consultants competent to assist with any language deficiency. In addition, when filing an application for registration of the disclosure document with the KFTC, a copy of the template franchise agreement must be submitted. If the template franchise agreement is in another language, a Korean translation must also be submitted. Therefore, it is necessary to prepare a Korean translation of the template franchise agreement to register the disclosure document.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

The main restrictions on provisions in franchise agreements under the Franchise Act relate to the receipt of certain types of franchise fees, duration and renewal of the franchise agreement, exclusive business territories of each franchised unit and procedures for terminating the franchise agreement. Aside from those, there are no notable restrictions imposed by the Franchise Act on the provisions in franchise contracts.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The Korean legal system is a civil law system, originally adopting the European civil law system and Japanese legal system. The Korean judiciary system is three-tiered and consists of the Supreme Court (the highest court), the high courts (the intermediate appellate courts) and the regional district courts (the courts of first instance). There are six high courts and 18 district courts, divided into geographical districts.

Alternatively, the parties in dispute may resolve disputes relating to the franchise agreement through mediation or arbitration. In particular, the Franchise Act provides that a franchise transaction dispute mediation committee may mediate matters related to disputes over franchise transactions if requested by the KFTC or by the parties in dispute. The franchisor is free to reject a mediation request. However, if mediation is requested due to an alleged violation of the MRFTA or the Franchise Act, it is advisable for the franchisor to comply with the request because, upon refusal, the franchisor may find itself subject to corrective measures under the Franchise Act.

The Korean Commercial Arbitration Board (KCAB) is the main institution of arbitration in Korea. The KCAB is dedicated to the settlement of commercial disputes as a neutral, unbiased and independent institution for administering and conducting arbitration, conciliation and mediation. Arbitration before the KCAB is an alternative way of producing impartial and fair resolutions to commercial disputes.

Governing law

43 Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

There are no restrictions on designating a foreign governing law in franchise documents. In fact, Korean courts readily enforce foreign governing laws. But, certain provisions of the Franchise Act (eg, renewal, business territory, cost-contribution on remodeling, termination procedure) are interpreted as mandatory, and thus, even if the franchise contracts are governed by foreign laws, the franchise documents must still comply with such provisions.

Arbitration – advantages for franchisors

44 What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

Unlike litigation before the Korean courts, arbitration awards are not appealable and, therefore, may resolve a dispute through a single proceeding. In addition, because arbitration procedures are not public, important information regarding the franchise transaction may be kept confidential.

However, arbitral proceedings may take longer than adjudication before the court of first instance (in many cases, the dispute practically comes to an end when the judgment of the court of first instance has been given) and, therefore, the dispute could be unnecessarily prolonged.

National treatment

45 In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Aside from minor differences in connection with the obligation to report real estate acquisitions and the restrictions imposed by the Foreign Investment Promotion Act, foreign franchisors are not treated any differently from domestic franchisors.

UPDATE AND TRENDS

Legal and other current developments

46 Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

The recent increase in the number of franchisors selling products online has led to a decrease in the sales of franchisees. To protect franchisees by providing sufficient information in advance, the Enforcement Decree of the Franchise Act was amended to require franchisors to disclose detailed information on product sales through the franchisor's online store (ie, the proportion of online sales and offline sales out of the franchisor's domestic sales, and the proportion of online exclusive and offline exclusive items sold by the franchisor). Furthermore, the amendment requires disclosure of information on the franchisor's directly managed store (ie, its name and location, average operation period, and average annual sales). The new disclosure requirements took effect on 19 November 2021, and therefore, any new disclosure document registrations and updates to registered disclosure documents filed after this date must include the new disclosures.

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In addition, there are several amendments to the Franchise Act that came into force in 2021. The majority of these amendments implement proposed measures, announced by the KFTC in November of 2021, aimed at addressing unfair franchising practices by franchisors and promoting the protection of franchisees' interests. Prior to the amendment, it was possible for franchisors who had not been verified by the market to offer franchises to franchisees. To address this issue, the amended Franchise Act requires that only franchisors with at least one year of experience in operating directly managed stores can offer franchises.

Furthermore, the amendment to the Franchise Act made on 4 January 2022, which is scheduled to take effect on 5 July 2022, further narrows the franchisor's authority by requiring the franchisor to obtain consent from a certain portion of the franchisees before holding advertising or promotional events whose expenses are borne by the franchisees in whole or in part.

Switzerland

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

No official statistics are available on the extent of franchising in Switzerland. According to the Syndicate Unia, there were estimated to be approximately 20 franchisors with 400 franchisees in the early 1970s and 150 franchisors, mainly foreign, in 2000. The market continued to increase significantly to reach 250 to 300 franchisors (with up to five franchisees each) in 2015, the vast majority of which expected to grow in the future according to a study conducted by the Swiss Franchise Association, which has recently rebranded to become Swiss Distribution.

However, the difficulty for franchisees to obtain a bank loan to finance their market entry does not facilitate market access.

According to Swiss Distribution, franchising is primarily present in retail, health and wellness, followed by gastronomy and fashion. The consulting and real estate sectors also count franchises, though to a lesser extent.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

Swiss Distribution is the leading association in the Swiss franchise industry. Franchise associations have a limited impact on the development of statutory laws and regulations. During the consultation procedure on preliminary drafts of new legislation affecting franchising activities, franchise associations and various stakeholders from civil society (political parties, interest groups, non-governmental organisations, etc) may express their opinions on the proposed bill.

Swiss Distribution has developed its Code of Conduct, which is binding to its members only (soft law). The Code of Conduct provides specific pre-contractual disclosure obligations and the specific duties of the parties to a franchise agreement. Indeed, a franchisor must demonstrate that it has successfully operated its franchising concept for a reasonable period of time (proof of concept) and must provide adequate initial training as well as commercial and technical support throughout the term of the franchise agreement.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

When it comes to setting up business in Switzerland, franchisors have a variety of legal forms from which to choose. However, the prevailing form of corporate vehicle established by a typical franchisor is the company limited by shares (AG), followed by the limited liability company (GmbH). Both AG and GmbH limit the personal liability of their holders for the debts of the company to their share of the corporate stock. However, only the AG may list on the Swiss stock exchange (the SIX Swiss Exchange or the BX Swiss).

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

In Switzerland, no regulations apply specifically to franchises and franchise relationships. The relevant legislation is, therefore, to be identified on a case-by-case basis.

In terms of the formation of business entities, the Swiss Civil Code (CC) and the Swiss Code of Obligations (CO) are relevant. The technical aspects of registration required for the formation of an AG or a GmbH are governed by the Commercial Register Ordinance.

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

The formation and maintenance of a business entity depend on the legal corporate form chosen. Nevertheless, the process follows the same steps for an AG and a GmbH. The business entity may be formed by one or more natural or legal persons (regardless of domicile or nationality) during an assembly, known as a constitutive assembly, in a notarial deed.

The articles of association must contain in particular the company name, seat and objects, the form of the company's external communications as well as the total amount of the capital, the extent to which it is paid up and the nominal value of shares. Irrespective of the size of the company, the minimum capital value of an AG is 100,000 Swiss francs, divided into shares with a nominal value of at least 1 Swiss cent (as of 1 January 2023, the nominal value of a share may be less than 1 Swiss cent but greater than zero), while that of a GmbH is 20,000 Swiss francs, divided into shares with a nominal value of at least 100 Swiss francs.

The franchisee is then registered in the public commercial register of the canton of its headquarters. The commercial register indicates, in particular, a list of the members authorised to act on behalf of the company. In the case of a GmbH, all listed individuals have

management powers. The company is liable for the actions of publicly registered persons.

Function and residency requirements apply to the latter. At least one member of the board of directors of the AG, respectively a managing officer of the GmbH or a member of the top management entitled to represent the company with sole signature power, must reside in Switzerland. If the signature power is joint, two members must reside in Switzerland.

Restrictions on foreign investors

6 | What restrictions apply to foreign business entities and foreign investment?

The franchise company must be represented by a person (ie, a member of the board of directors or a director domiciled in Switzerland).

Foreign franchisors must also be aware that, according to the Federal Act on the Acquisition of Real Estate by Persons Abroad, natural and legal persons with their registered office or domicile abroad as well as persons acting on their behalf may only acquire real estate in Switzerland after an authorisation procedure. However, the purchase of real estate for commercial use (eg, hotels, shops, offices and production halls) does not require authorisation.

No other restrictions currently apply to foreign business entities or foreign investment.

Taxation

7 | What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

In terms of taxation, the Swiss federal system means that tax powers and revenues are shared between the Swiss Confederation, the cantons and the municipalities. Businesses and individuals are therefore taxed on all three levels. While the Swiss Confederation is competent exclusively in areas that the Swiss constitution provides for, the cantons are sovereign in tax matters, which means in particular that they have a general competence to collect taxes, determine tax-exempt amounts, and set tax scales and rates. Thus, the level of taxation and the tax burden varies between cantons and each canton has the power to influence its tax competitiveness directly. This system has developed a domestic tax competition and led to relatively low tax rates in Switzerland in comparison with other jurisdictions.

Natural persons residing or staying for a certain period of time in Switzerland are subject to income and wealth tax. Foreign persons not benefiting from a permanent resident permit (the C permit) are, in principle, taxed on their income from Swiss sources by means of a withholding tax. However, admission fees and royalties paid to foreign franchisors are generally not taxed by withholding.

Legal entities, such as franchisees formed in AGs or GmbHs, residing in Switzerland are subject to tax as soon as they are entered in the commercial register or if they have their effective place of management in Switzerland. Profit tax is levied at the federal, cantonal and municipality levels (ie, by the Swiss Confederation, the cantons and the municipalities). Relative tax rates are, for the majority of the cantons, flat tax rates applying on the taxable profit of a legal entity (progressive tax rates are the exception).

Depending on the location, it is not unusual to expect a rate between 14 and 17 per cent for income tax. Taxable income is determined through the statutory accounts or, in the case of a foreign company, the branch accounts. The assessment for income tax is made on net profit after tax (tax expenses being deductible in Switzerland) as shown in the statutory financial statements that must follow the CO accounting standards. Companies that are not registered per se in Switzerland but are active in the country through a permanent establishment or a branch are only taxed on profits generated by the Swiss activity or on real estate assets located in Switzerland. According to a judgment of the Federal Supreme Court (BGer 134 I 303), the activity of a franchisee does not, however, constitute a permanent establishment of the franchisor, even if the premises belonging to the franchisor are leased to the franchisee. Except for the taxation of an eventual rental income, no tax obligations arise for franchisors in the cantons where their franchisees are domiciled with regard to the franchise agreement as such.

After the rejection of earlier reform packages, the Swiss electorate agreed in May 2019 on a major tax reform, which had been debated at length. The reform aimed to align the Swiss tax system with international standards regarding corporate taxation. In general, the reform has increased the tax burden of large companies while reducing that of small and medium-sized enterprises. It implied the suppression, as of 1 January 2020, of special privileges granted to internationally active companies. To maintain a fiscally attractive business location, the fiscal reform introduced, among other things, the possibility to introduce a deduction of up to 50 per cent of research and development costs on the cantonal level and a 'patent box' system allowing profits from inventions to be taxed at a reduced rate on the cantonal level.

The Swiss value added tax (VAT) is only collected on the federal level.

Since January 2019, foreign persons with a turnover of at least 100,000 Swiss francs through deliveries in Switzerland are subject to domestic tax.

Taxable persons are required to register and responsible for declaring the tax due. The standard VAT rate is 7.7 per cent. Reduced rates are applied to some services and products, namely accommodation (at a rate of 3.7 per cent) and essential goods and services such as non-alcoholic beverages, food, medicines and books (at a rate of 2.5 per cent). In this framework, services related to franchise relations are subject to ordinary VAT.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

In Switzerland, franchisees are considered independent entrepreneurs rather than employees of the franchisor. However, the franchise contract is not regulated as such by Swiss law but is a 'mixed' contract, which means that it consists of elements of several contracts regulated by the CO. It is, therefore, necessary for each matter in dispute to identify the predominant elements of the particular relationship to determine the regime applicable to the given case. On the basis of these principles, the Federal Supreme Court confirmed, in its judgment BGer 118 II 157, the application by analogy of labour law provisions providing for compensation of the employee in the case of wrongful termination in a case where the franchisor held a particularly dominant position in relation to the franchisee, who was limited in its entrepreneurial freedom. This risk can be limited by ensuring that the franchisee enjoys genuine and broad entrepreneurial freedom. However, the risk of equating the franchise relationship with subordination remains in two respects.

In the case BGer 134 III 497 concerning a distribution contract, the Federal Supreme Court concluded that the agent's protective provisions provided for in the provisions governing the commercial agency contract were applicable by retaining a relationship of subordination between the licensor and the distributor. This judgment may suggest that a franchisee might, in the same way, be protected as an agent even in the case of tenuous subordination to the franchisor. On the other hand, if a non-competition agreement has been concluded, part of Swiss legal literature states that the franchisee may be entitled to special remuneration when the franchise agreement is terminated.

Unfortunately, the Federal Supreme Court has neither decided on nor outlined the answer to either of the latter two points.

Intellectual property

9 How are trademarks and other intellectual property and know-how protected?

The Swiss Trade Mark Protection Act (TmPA) provides that any sign (such as words, letters, numbers and graphics) distinguishing the goods or services of one company from those of another may be registered as a trademark. Registration grants the holder an exclusive right to use the mark on the registered goods and services and the protection of his or her right for a 10-year period, which may be renewed an unlimited number of times. However, well-known trademarks within the meaning of article 6-bis of the Paris Convention benefit from protection not only for registered goods and services, but also for any non-registered ones. The Swiss Federal Institute for Intellectual Property is in charge of processing applications for registration. The application may be filed by more than one person intended to be a holder of the right to use the trademark, without any requirement as to residence, headquarters or nationality being applicable. Since Switzerland is a party to the Madrid International Trademark System, the national registration can be supplemented by an international registration handled by the World Intellectual Property Organization in Geneva.

No proof of use of the trademark is required for registration. However, to avoid trademarks being registered as a reserve, the trademark must be used for its protection to take effect. If the owner does not use the trademark during the five years following registration, his or her right shall be forfeited if non-use is not justified and action may then be brought to cancel the registration.

Unauthorised use of a trademark identical or confusingly similar to a registered trademark shall be deemed to be an infringement. In such a case, Swiss law provides injunctive or prohibitive civil actions as well as other protective measures. The owner of the trademark may also demand financial compensation by means of a request for royalties, compensation of damages or the repayment of profits made by the infringer. Furthermore, the TmPA provides for criminal sanctions, upon complaint, of any unlawful use of another's trademark by a sentence of up to one year's imprisonment. In addition to civil and criminal remedies, the TmPA enables the owner of a trademark to oppose the entry in the register of an infringement of his or her trademark within three months following the publication of said infringement's registration.

Know-how is in Switzerland neither protected by specific legislation nor by Swiss regulations protecting intellectual property. In the case of unfair competition through the use of know-how, the Federal Act against Unfair Competition does, however, allow the franchisor to file a complaint. The case of unfair competition is then punishable by a pecuniary penalty or a sentence of up to three years' imprisonment. Know-how may also be protected by a clause in the franchise contract qualifying it as confidential information. The disclosure of the know-how could thus be pursued through the legal means available in the case of breach of contract. In addition, the Swiss Criminal Code punishes, upon complaint, the breach of manufacturing or trade secrecy with a pecuniary penalty or imprisonment of up to three years.

Real estate

10 What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

Franchisees do not usually own their own premises and usually lease them in the main cities of Switzerland. The franchisor may sometimes be the owner of the premises where the franchising activities are to be operated by the franchisee. In this specific set-up, the franchise contract also deals with the lease of the premises, and the franchisor–franchisee relationship may become a hybrid one combining franchising and commercial lease aspects.

Swiss law does not provide for specific legislation on commercial leases, but rather for one-off changes to the regime applicable to any lease contract. Local franchisors, as well as foreign franchisors, are free to enter into and arrange their lease relationships provided that mandatory tenants' protection provisions are complied with. As any lessee, franchisors are thus protected against abusive rent rates as well as by provisions requiring compliance with specific formalities upon the termination of the lease. Given the depreciation period of investments made and the inconveniences associated with moving a business, commercial leases are often longer than residential leases and must be terminated with at least six months' notice. If the landlord terminates the lease, the tenant may request an extension of the lease for a period of up to six years provided the circumstances justify it. It should also be noted that the installation and alteration of premises by lessees must be authorised by the owner and may give rise, at the end of the lease, to compensation for the lessee who financed them. It is, nevertheless, recommended that this matter be addressed more closely in the lease contract.

The CO requires the notarisation of the 'promise to sell' and the 'purchase of real estate'. When purchasing a building plot or changing the use to which the purchased property is to be put, land planning regulations and authorisation processes must also be taken into account.

In addition to these regulations, foreign franchisors must observe the restrictions imposed by the Federal Act on the Acquisition of Real Estate by Persons Abroad (BewG). According to the BewG, 'persons abroad', which are physical or legal persons domiciled or having their registered office abroad, as well as persons acting on their behalf, may acquire real estate in Switzerland under conditions verified in an authorisation procedure.

However, according to the BewG, the purchase of real estate for commercial use is not subject to authorisation. Hotels, retail premises, offices and manufacturing halls, for instance, are considered properties for commercial use.

Competition law

11 What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

Franchising activities are governed by Swiss competition law, namely the Federal Cartel Act, the Federal Act on Price Supervision and the Federal Act against Unfair Competition. Indeed, a franchise agreement qualifies as a vertical restraint between two entities and is subject to the same legal assessment as a traditional distribution contract. Swiss competition law tends to be compatible with Commission Regulation (EU) No. 330/2010 of 20 April 2010 and general European practice. However, in the *Gaba* case (BGer 143 II 297), the Federal Supreme Court refused to apply an EU regulation on technology transfer agreements under Swiss law.

On 22 May 2017, the Swiss Competition Commission (ComCo) published a notice concerning the assessment of vertical agreements (CommVert) and related guidelines containing detailed rules that may also apply in franchise relationships (eg, cross-supplies, non-compete obligations, know-how and resale prices).

A franchise agreement is deemed to be illegal and invalid if it provides for a minimum or fixed price for a product, or for the allocation of territory between different franchisees by preventing passive sales by other franchisees into those territories. A general prohibition of online sales in franchise agreements qualifies as an illicit hardcore

restriction, as internet sales are considered passive sales pursuant to the CommVert (which may not be subject to an absolute prohibition) unless the website specifically targets customers in an individual territory (active sale).

Other restrictions may also qualify as hardcore restrictions, such as technical geoblocking measures, rerouting customers or restricting sales to customers located outside the contractual territory based on the information provided (eg, foreign credit cards) as those restrictions achieve the same goal of restricting passive sales to customers located outside a contractual territory.

In the latest development in the *Pfizer* case (BGer 2C_149/2018, judgment dated 4 February 2021), the Federal Supreme Court held that recommended resale prices issued by Pfizer and made available to pharmacies through a third-party database that was directly connected to the cash registers of the pharmacies qualified as unlawful resale price maintenance. Notably, 89.3 per cent of the pharmacies supplied by Pfizer had fully or partly applied the recommended resale prices. The compliance of 50 per cent of the retailers appears to be sufficient for there to be a concerted practice. The fact that Pfizer has never exerted pressure on or offered special incentives to the pharmacies was not relevant. Pursuant to this judgment, non-binding price recommendations may be seen as problematic in Switzerland, especially when those recommendations are repeatedly and automatically communicated in the retailers' cash register systems. This ruling is stricter than the corresponding rules under European competition law.

The exposure of the parties to a franchise agreement that breaches Swiss competition law may be important. If a franchise agreement is found to contain illegal clauses, the parties may be fined up to 10 per cent of the turnover achieved in Switzerland in the preceding three years, without prejudice to potential civil claims.

Finally, a revision of the Federal Cartel Act and the Federal Act against Unfair Competition came into force on 1 January 2022. This revision implements the Fair Price Initiative, which aims to enable the purchase of products outside of Switzerland in potentially more favourable purchasing conditions. The revision establishes various new behavioural obligations for companies that are powerful relative to their market, prohibits discrimination while procuring goods and services abroad, and prohibits practices of geoblocking. The revised provisions may have a material impact on franchising activities in Switzerland.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

As Swiss legislation does not specifically define franchising, the concept has been developed by case law and legal literature. According to a leading decision of the Federal Supreme Court (BGer 118 II 157), in concert with the legal literature and the Swiss franchising association Swiss Distribution, a franchise agreement consists of the distribution of goods or services by independent entrepreneurs (the franchisees) according to a uniform concept of sale and advertising provided by the franchisor. For this purpose, the franchisee receives the right to use the franchisor's name, trademarks, equipment or other material or immaterial property rights as well as ongoing assistance, advice and training from the franchisor. Although the franchisee acts on its own behalf and at its own risk, the franchisor reserves, as a general rule, the right to give instructions and exercise control over the franchisee's business activity. The Federal Supreme Court stated, however, that the variety of forms in which franchise agreements are drawn up makes it impossible to define a franchise agreement 'with sufficient precision'. In any event, the relationship involves very close cooperation between the franchisor and the franchisee.

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

The offer and sale of franchises are not specifically governed by any law in Switzerland. In terms of law, the general provisions of the Swiss Civil Code (CC) and the Swiss Code of Obligations (CO) apply as well as the United Nations Convention on Contracts for the International Sale of Goods, if not waived. The General Data Protection Regulation of the European Union, the Swiss Federal Act on Data Protection and the Swiss laws on intellectual property may also apply to the offer and sale of franchises. The important role of the principle of good faith in relation to the behaviour of the parties, which must be serious (serious intent to contract), as well as the disclosure of information during contractual negotiations should also be stressed.

Where general terms and conditions (GTC) are involved, although the general rules of the CC and the CO apply, case law of the Federal Supreme Court has developed specific rules regarding the adoption and interpretation of the GTC, which must also be taken into account. In particular, the GTC must be validly incorporated in the contract to be effective and, in any case, the agreement between the parties has priority over the GTC's content. Moreover, the Federal Act against Unfair Competition prohibits the use of GTC that provide for a significant and unjustified imbalance between the rights and obligations of a business and a consumer to the latter's detriment.

Accordingly, there is no government agency regulating franchises. However, Swiss Distribution, which is a private commercial organisation with no governmental function and self-regulated, provides a framework for its members.

Principal requirements

14 | What are the principal requirements governing the offer and sale of franchises under the relevant laws?

This is not relevant in Switzerland.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

Swiss law does not provide for such requirements. However, Swiss Distribution does require franchisors and master franchisees aspiring to become members to meet certain requirements, such as a proof of concept, a minimum of two years of franchising and a franchise system comprising of at least two franchisees. It should, moreover, be noted that franchisees cannot join Swiss Distribution.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

Swiss law does not provide for any special regulations in this area and gives free scope to contractual freedom. Franchisors and master franchisors may, with the consent of their co-contractor, apply possible restrictions. Notwithstanding the foregoing, the new provisions of the Federal Cartel Act provide for new behavioural obligations for companies that powerful relative to their market.

In line with EU rules, if the franchisees' network qualifies as a selective distribution system based upon quantitative or qualitative criteria, or

both, franchisors are required to apply those criteria in a uniform and non-discriminatory manner when selecting the candidates to a franchise agreement.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

The procedure for making pre-contractual disclosure in connection with franchise contracts is not regulated by special statute under Swiss law. However, according to the principle of good faith, not only must all of the information disclosed during the pre-contractual phase be true, but the prospective franchisee must receive all the necessary information concerning the projected contractual relationship. In this context, Swiss Distribution has issued its Code of Conduct, supplemented by specific advice concerning the pre-contractual phase. Regulations issued by Swiss Distribution are binding only to its members and, in the case of its Code of Conduct, apply only to the relationship between franchisor and franchisee. However, as this information is available on Swiss Distribution's website, it can serve as an illustration for franchisor or master franchisee.

In general, for evidentiary reasons, it is recommended to keep a written record of any information transmitted.

Pre-contractual disclosure – content

18 | What information is the disclosure document required or advised to contain?

There are no specific pre-contractual statutory disclosure regulations pursuant to Swiss law in a franchise context. According to the principle of good faith, the prospective franchisee must receive all the necessary information concerning the contemplated franchising activities prior to the execution of the franchise agreement. In addition, all of the information disclosed during the pre-contractual phase is to be true and not misleading. For evidentiary reasons, it is recommended to keep a written record of any information transmitted.

In its Code of Conduct, Swiss Distribution lays out specific pre-contractual disclosure obligations that are binding for its members only (soft law). The franchisor member of Swiss Distribution is thus required to provide the prospective franchisee with full written information concerning the terms of the franchise agreement within a reasonable period of time before the execution of the franchise agreement. Moreover, all information provided to the franchisor must be factually correct and void of ambiguity and misleading information.

Pre-sale disclosure to sub-franchisees

19 | In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Under Swiss law, sub-franchise relationships are not governed by a special statute or monitored by a specific agency. Therefore, according to the principle of freedom of contract applicable under Swiss law, the parties to the sub-franchising structure decide by consensus which of them will make pre-sale disclosures to sub-franchisees.

Due diligence

20 | What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

Under the Swiss Distribution's Code of Conduct, which is applicable to its members, the franchisor must conduct an investigation to determine whether a potential franchisee has the required qualities to operate the franchise in question (in other words, adequate training, financial capacity and personal qualities).

Since the reputation of the franchisor is directly linked to that of its franchisees, it is also necessary to ascertain the practices of the prospective franchisee in its business activity and in particular, if the prospective franchisee has employed staff, ensure compliance with labour law obligations.

However, the franchisee is advised to carefully examine the franchise of interest to the franchisee. In this regard, the Swiss Federal Department of Economic Affairs, Education and Research recommends that potential franchisees consider the following questions:

- How long has the franchisor been on the market?
- What skills and experience does management have?
- Are there any references?
- How is the financial situation presented?
- How is the company image presented?
- How many franchise managers are there and how long have they been franchise managers?
- Does the franchisor perform an aptitude test with applicants?
- Is the franchisor a member of a professional association?
- Is the franchisor trying to manipulate prices?
- Do you have to buy the merchandise and production resources from the franchisor?
- Is professional and commercial knowledge necessary?
- Is there comprehensive training and good preparation for the business?
- Is there a manual on how to manage the business?
- Are help and advice available if required?
- What services does the franchisor offer in terms of buying, advertising and PR?

Swiss Distribution further invites prospective franchisees to consult the selection criteria applicable to franchisees and to answer a series of questions to determine whether they are 'fit to buy'. Likewise, a 'fit to sell' test is available for franchisor self-assessment. In addition, Swiss Distribution's advice on the pre-contractual phase included in its Code of Conduct is relevant.

Failure to disclose – enforcement and remedies

21 | What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

Swiss law recognises and applies the *culpa in contrahendo* and the 'error as to the basis of the contract' doctrines. If the franchisor hides information that had discouraged the franchisee from entering into the franchise contract with the franchisor or if a franchisee enters into a franchise agreement based on a material misrepresentation of the operation, the franchisee may rescind or cancel the franchise agreement.

The damage to be claimed by the franchisee arising out of a *culpa in contrahendo* is equivalent to the difference between the current wealth of the franchisee in its capacity as the injured party and the wealth he or she would hypothetically dispose of without the damaging event (ie, the conclusion of the franchise agreement). However, claims based on *culpa in contrahendo* are only admitted exceptionally by the Swiss courts.

If a franchisee rescinds a franchise agreement based on an error as to the basis of the contract resulting from its negligence (eg, by not requesting sufficient information before entering into the franchise agreement), the franchisee may be liable to pay damages to the franchisor amounting to the negative interest (ie, the amount of useless cost suffered by the franchisor that was caused by negotiating and entering into the cancelled franchise contract).

Failure to disclose – apportionment of liability

22 | In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Unless the parties have contractually provided otherwise, a sub-franchisor is liable to its sub-franchisee for disclosure violations in the same way that the franchisor is liable to the sub-franchisor. The franchisor is, in principle, not liable to the sub-franchisee. However, on the basis of the reasoning followed in judgment BGer 118 II 157, where the sub-franchisor is in a subordinate relationship to the franchisor then the franchisor could assume liability for violations by the sub-franchisor in the same way that an employer bears liability for the violations committed by its employee under the provisions governing employment law.

In Switzerland, the liability of individual officers or directors of a franchisor or sub-franchisor is limited if the business is formed as a company limited by shares or a limited liability company. Such executives would only be held directly or indirectly liable in the case of an intentional or negligent breach of duty of care. For damages caused by employees in the performance of their work, liability is generally borne by their employers. Furthermore, where disclosure violations infringe a criminal provision, for instance in matters of unfair competition, individual officers, directors and employees may incur direct liability.

General legal principles and codes of conduct

23 | In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

The offer and sale of franchises are not specifically governed by any law in Switzerland. General provisions of Swiss law remain applicable. However, the CC and the CO apply as well as the United Nations Convention on Contracts for the International Sale of Goods, if not waived by the parties. Those statutory provisions may impact the terms of the franchise contract; the General Data Protection Regulation of the European Union, the Swiss Federal Act on Data Protection and the Swiss laws on intellectual property may also apply to the offer and sale of franchises. Moreover, the Federal Act against Unfair Competition prohibits the use of general terms and conditions that provide for a significant and unjustified imbalance between the rights and obligations of a business and a consumer to the latter's detriment.

Pursuant to Swiss law, the principle of good faith plays an important role with respect to the conclusion and the performance of a franchise contract, in particular in relation to the behaviour of the parties, which must be serious (serious intent to contract), as well as the disclosure of information during contractual negotiations.

In contrast to common law jurisdictions, the interpretation of franchise contracts pursuant to Swiss law tends to focus on the real intention of the parties rather than on the terms of the contract. Indeed, should a provision of a franchise contract require interpretation, a judge will first seek to establish the real and common intention of the parties, adopting an empirical approach. When the actual intent of the parties cannot be ascertained on the basis of factual evidence, the provision is to be interpreted in accordance with the principle of trust and in accordance with the rules of good faith. The judge then gives the unclear provision the meaning that a person placed in similar circumstances, having a similar background as that of the parties, would reasonably do.

There is no government agency regulating franchises. However, Swiss Distribution provides a framework for its members, including its Code of Conduct. Even though the rules and regulations of Swiss Distribution are not binding (at least for non-members of this association), they can serve as an illustration for a franchisor or franchisee.

Fraudulent sale

24 | What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

In the case of fraud or deceptive practice, several possibilities are, depending on the circumstances, open to the franchisee. The franchisee may take civil action for breach of contract and claim damages, rescind or terminate the franchise contract as well as claim damages or challenge the franchisor on the basis of the unfair competition act.

The franchisee may also file a criminal complaint if the franchisor's conduct can be qualified as *escroquerie* within the meaning of the Swiss Criminal Code. The criminal complaint is, in principle, directed against a physical person. However, if the failing organisation of the incorporated franchisor does not make it possible to determine which person is responsible for the *escroquerie*, then the company may be sanctioned with a fine of up to 5 million Swiss francs.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 | What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The general rules of the Swiss Civil Code (CC) and the Swiss Code of Obligations (CO) regulate the ongoing relationship between franchisor and franchisee. Depending on the structure of the relationship between franchisor and franchisee, the topical regulation of various specific contracts provided for in the CO may additionally apply, in particular the provisions on the employment contract and the agency agreement.

Operational compliance

26 | What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

A right to direct and control the franchisee is reserved to the franchisor in a typical franchise agreement. In this context, the concrete control mechanisms taken by the franchisor usually consist of an inspection of the franchisee's premises and control of the franchisee's accounts. Usually, the franchisee is also required to report periodically to the franchisor on the conduct and impact of their business. Such reports may cover all matters relating to quality, health, safety, security and environmental friendliness. This could include, for example, customer satisfaction and the labour conditions of employees, if any. In consideration of the long-term nature of the franchise relationship, additional reporting could be provided for, in the case of, for instance, an internal incident, an audit or new directives given by the franchisor. The scope of the mechanisms varies according to the standards applicable to the

franchise branch. For example, in the gastronomy and food retail sector, a daily report of food freshness and quality management may be introduced and the inspection of the cleanliness of the premises must be particularly meticulous to protect the customers' health as well as the reputation of the company.

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

Unilateral modifications of the operational terms and standards are admissible if they are contractually provided for by the parties and do not amount to a modification of the contract in itself. Indeed, the contractual freedom of the parties and the principle of pacta sunt servanda are limited by the fundamental principle in Swiss law according to which the conclusion and modification of a contract can only take place through the expression of the concordant will of the parties.

Policy affecting franchise relations

28 | Do other government or trade association policies affect the franchise relationship?

Swiss Distribution's Code of Conduct applies to franchise relationships. These principles are, however, only compulsory for the members of the association. Although optional, the membership to Swiss Distribution represents a pledge of professionalism, and is noteworthy for its positive impact on the business practice and reputation of the franchisor.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Franchise agreements may be concluded for a fixed or indefinite period. In the first case, the relationship expires at the agreed term without the intervention of the franchisor, unless the parties have agreed otherwise.

Franchise agreements are usually for a fixed period of time, at the end of which the contract is automatically or tacitly extended. In such a case, the contract is then considered to be of indefinite duration and comes to an end, if the parties have not provided otherwise, by termination with six months' notice (by analogous application of the rules on partnership contracts supported by the majority of the legal literature), by mutual agreement or, exceptionally, by the invocation of motive (good cause) justifying the immediate termination of the relationship (on the basis of the BGer 4A_241/2017 judgment). According to case law of the Federal Supreme Court concerning an exclusive distribution contract (BGer 107 II 216), the contract must in any case extend over a sufficiently long period of time for the franchisee to make a return on his or her initial investment of capital and preparatory work. Should the franchisee not be exclusively related to the franchisor, a court might take into account the reduced scope of the relationship compared to an exclusivity.

Even in the absence of an express rule, the immediate termination of the relationship for good cause is presumed to be justified where the continuation of the contractual relationship would, according to the rules of good faith, be unacceptable to the terminating party. Notice of immediate termination must reach the other party within a relatively short period of time after the occurrence of the good cause. To provide guidance to the parties, the contract may define and illustrate the notion of good cause. However, in a case concerning a franchise agreement (BGer 4A_148/2011), the Federal Supreme Court stated that such clauses do not bind the judicial authorities if they limit the possibility of immediate termination if a good cause not listed or not corresponding to the definition of the parties arises. While the Federal Supreme Court has recognised the principle of immediate termination of a franchise agreement for good cause, it has not yet had the opportunity to decide on the effects of such termination in the absence of any valid good cause.

The case law of the lower courts as well as the Swiss legal literature consider that the absence of good cause prevents the immediate termination of a franchise agreement. The parties, therefore, remained bound to fulfil their contractual obligations, failing which a civil injunction could be issued against the recalcitrant party (BGer 125 III 451). If the concrete relationship between the parties justifies the application by analogy of the provisions of the CO on employment contracts, an unjustified immediate termination would still be effective and the franchisee would be entitled to compensation, the amount of which, determined according to all the circumstances of the case, would correspond at most to the amount that the franchisor would have earned if the contract had been terminated at the agreed expiry or after the applicable notice period. Likewise, any other type of abusive termination entitles the franchisee in a subordinate relationship to the franchisor to claim compensation (BGer 118 II 157).

In the event of non-renewal of the franchise agreement or termination with notice, the franchisee may also claim compensation for, depending on the situation, loss of customers and not amortised investments. However, there is some doubt on this issue because the legal authors are not unanimous and the Swiss Federal Supreme Court has not ruled on the matter. It can be, however, expected that the compensation of the franchisee in such a case will vary according to the applicable regime by analogy to the concrete situation.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

Regarding the termination of contractual relations, the franchisee disposes of the same means and is subject to the same rules as the franchisor. It should be pointed out, however, that in the event of non-renewal of the franchise agreement or termination with notice, it is unlikely that the franchisor would be eligible for compensation for customer loss since the clientele generally remains loyal to the brand rather than to the franchisee.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

Unless the parties have provided for a particular form or substantive requirement, the common will of the parties to renew a franchise agreement subject to a limited duration must be expressed in the same form as the initial agreement or by means of an amendment. Nevertheless, if the parties continue to perform their respective services after the expiry of the contract, the latter may be deemed to be tacitly renewed. If the franchise agreement is of unlimited duration or renews itself from year to year without the intervention of the parties, no formal renewal is necessary.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

By virtue of the contractual freedom of the parties, the franchisor is in principle entitled to refuse to renew an agreement with a franchisee. However, the refusal to maintain business relations by a franchisor with

a dominant market position could be unlawful according to the Federal Cartel Act (CartA). In such a case, the franchisor's refusal to renew the franchise agreement would not be legally justifiable. The new provisions of the CartA introduce new obligations for entities with relative market power. Indeed, companies upon which other companies are dependent in terms of supply or demand, even though they do not reach a 40 to 50 per cent market share threshold on the relevant market, are subject to the existing provisions regarding the abuse of a dominant position and therefore may be restricted in their capacity to refuse to deal with dependant companies. A company may be considered as a dependant of an entity with relative market power if it does not have sufficient or reasonable possibilities to switch to other companies.

Furthermore, franchisors should be aware that, regardless of their position in the market, if they refuse to renew the agreement they are liable to compensate any investments that the franchisee may have made in good faith (ie, on the basis of a promise or intention to renew the franchise agreement expressed by the franchisor). Along the same lines, one must also take into consideration the indemnification of the franchisee if the term of the contract was not sufficiently long to allow for the amortisation of the franchisee's investments.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Such restrictions are admissible to the extent provided for in the franchise agreement.

Depending on the will of the parties, the restrictions may consist of a prohibition, such as a right to terminate the entire franchise agreement in the event of a transfer of ownership (change of control clause), or a limitation on any transfer of ownership, including pledges, by requiring the franchisor's approval. The requirement for prior written approval from the franchisor for transfers is, however, the most common modality in practice.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

The nature, amount or payment of fees generally depends on the choice of the parties expressed in the franchise agreement. However, the provisions and general principles applicable to contracts subject to Swiss law allow the franchisee to terminate the contract within one year of its conclusion and claim for the reimbursement of the entry fees paid under two conditions:

- the fee to be paid by the franchisee is manifestly out of proportion with the franchisor's counter-performance to the detriment of the franchise; and
- such disparity results from the exploitation of the franchisee's distress, inexperience or improvidence by the franchisor.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

The general provisions of the CO provide for an interest rate of 5 per cent. However, the franchise agreement may provide for a lower or higher interest rate. In such a case, the rate must not be excessive, otherwise it is considered as usury punishable by a pecuniary penalty or imprisonment for up to 10 years. This limit is estimated to range between 10 and 15 per cent.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No, provided that the parties have agreed upon the chosen currency.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are enforceable. In the case of a breach of contract, the aggrieved party may initiate a civil action to order compliance with the clause and claim damages. It is recommended to add to the contract, in addition to the confidentiality clause, a penalty clause stipulating that any breach of contract will be punished through the payment of a fee or any other contractual penalty. Besides encouraging the parties to comply with the contract, such a clause helps to avoid the additional difficulty often encountered in proving the amount of damages in civil proceedings by fixing a lump-sum compensation in advance.

Depending on the information revealed to a third party, a breach of confidentiality may, furthermore, constitute a criminal act.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Objectively, good faith is the foundation of loyalty in business and governs the whole area of contract law. The idea is that every person involved in a legal relationship is bound by general duties dictating one's conduct, which means that everyone must behave as an honest, loyal and respectful person would behave towards others. The principle is therefore based on social ethics and a sense of justice. The normative consequences of this principle are mostly developed by case law. Good faith thus has many applications. For example, BGer 125 III 257 developed the prohibition of contradictory behaviour of the parties to the franchise agreement on the basis of good faith.

Subjectively, good faith is the feeling of acting lawfully despite the existence of a legal irregularity. It may represent a legal requirement or influence the burden of proof.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

As a general rule, franchisees are treated as entrepreneurs and not as consumers under Swiss law and jurisdiction. Only franchisees who are considered a weak party with respect to their franchisor's position may benefit from the protection afforded to employees.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

Disclosure documents and franchise documents must be in one of the official Swiss languages. Franchisors and franchisees are free to choose which of these official languages they wish to use in their contracts. The parties must nevertheless be aware of the consequences of their choice on possible legal proceedings.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

By virtue of freedom of contract, restrictions placed on the franchisees are subject to the parties' discretion. They may consist of a prohibition of performance by substitution, an obligation to obtain supplies principally or exclusively from the franchisor by applying, where appropriate, the prices indicated or its recommendations. However, such restrictions are regulated by the CartA. Furthermore, the principle of good faith as well as the CC and the CO may protect the franchisee against excessive or overly restrictive commitments.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The Swiss Court system distinguishes between civil, criminal and administrative courts.

Legal proceedings are conducted in one of the three official languages, namely German, French or Italian. The language is, in principle, that of the place where the proceedings were initiated. Evidence in a language other than the language of the proceedings must be translated. Exceptionally, some courts (the Federal Patent Court, if the parties to the proceedings agree, and some commercial courts) accept the filing of evidence in English.

Typically, proceedings may be conducted successively in three levels of courts. The cantons usually provide for two courts. In civil matters, the cantons may introduce commercial courts as the sole cantonal instance for commercial matters. Sole cantonal instances further exist in all cantons for disputes in connection with intellectual property rights, antitrust and unfair competition law. In addition, certain cases are directly and exclusively handled by a federal authority. For example, this is the case for patent disputes, for which the Federal Patent Court has exclusive jurisdiction.

The Federal Supreme Court, the highest court in Switzerland, acts as the last ordinary Swiss court of appeal.

The majority of Swiss judges are professionals. However, some of them are laymen (ie, they have not received any legal training). The commercial court judiciary is, furthermore, composed of specialised lay judges, chosen for their expertise in the relevant area of litigation. Technical cases can thus be handled with a combination of legal and technical expertise.

Although the Swiss Court system is exhaustively governed by the applicable law, franchisors and franchisees have the right to elect a forum and a law applicable to their dispute. When making such a choice, however, the Federal Act on Private International Law (PILA) and the Lugano Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters (applicable in Switzerland) must be taken into account. Thus, despite a choice of court, a breach of competition rules by one of the parties in the performance of the contract could, for example, be the subject to proceedings before the court of the place where the damage occurred, provided that the contractual aspect of the dispute is not preponderant (CCIV.2017.3 judgment of 25 September 2018 by the Cantonal Court of the Canton of Neuchâtel).

In lieu of Swiss courts, the parties may, furthermore, agree to arbitrate their disputes.

Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

The parties to a franchise agreement are generally free to agree on the governing law and to choose a foreign governing law. The choice of law may be made or amended at any time. If a choice of law is made after the execution of the contract, it has a retroactive effect as of the time of conclusion of the contract (article 116, paragraph 3 of the PILA).

Although it is not recommended, disputes arising from franchise agreements governed by a foreign law may be subject to the Swiss courts, provided they have jurisdiction. In such case, it is the responsibility of the parties to prove the content of the chosen foreign law. However, Swiss courts will not apply foreign governing law if it breaches Swiss public policy or Swiss mandatory laws that, by reason of their special purpose, are applicable regardless of the chosen governing law (articles 17 and 18 of the PILA).

Arbitration – advantages for franchisors

44 | What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

Arbitration has the advantage of providing a tailor-made dispute resolution because the parties are free to determine the terms of the procedure. In cases where the award is not subject to appeal and the documents are not in one of the official Swiss languages, arbitration may save the parties time. Moreover, arbitration is particularly suitable for disputes that the parties wish to resolve with all available discretion.

Swiss law fully recognises the coexistence of state judgments and arbitral awards, whether they are rendered to parties based in Switzerland or abroad. Arbitral awards are also taken into account, recognised and even protected by the Federal Supreme Court. Indeed, according to consistent federal case law, only a gross violation of fundamental rights (such as the right to be heard and the right to a fair trial) constitutes grounds for appeal against an arbitral award before the Federal Supreme Court. The legal remedies available to challenge arbitrators' decisions are thus particularly limited. Furthermore, the Swiss Arbitration Centre (successor of the Swiss Chambers' Arbitration Institution), offers means of dispute resolution based on the Swiss Rules of International Arbitration. It is probably for these reasons that Switzerland is a particularly popular place for arbitration.

However, the Swiss courts have a good reputation and solutions that are particularly suitable for commercial disputes are available. Before opting for arbitration, foreign franchisors should evaluate whether arbitration would be advantageous in their particular situation. For example, the costs of arbitration remain high despite the absence of appeal if the dispute involves a small monetary amount. Moreover, arbitration requires the agreement of the parties as well as a supplementary prior investment by the parties in its organisation.

In short, even if Switzerland is particularly attractive for arbitration proceedings, it is recommended to reserve this mode of dispute resolution for disputes involving large sums of money or that must be kept secret.

National treatment

45 In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

In Switzerland, foreign franchisors are treated differently from domestic franchisors with respect to the acquisition of real estate and, only for natural persons, with respect to obtaining residence and work permits.

Owing to the particularly close relations between Switzerland and European countries, citizens of the European Union (excluding Croatian) and European Free Trade Association countries benefit from the free movement of persons and, therefore, have an advantage over other foreign nationals in obtaining residence and work permits.

UPDATE AND TRENDS

Legal and other current developments

46 Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

Four ongoing reforms of existing legislations and proposals for new legislation are likely to change the regulations impacting franchises.

First, the Swiss parliament passed the total revision of the Swiss Data Protection Act (DPA) on 25 September 2020. The purpose of the DPA revision (which originally came into force in 1992) was to adapt the outdated law to today's social and technological conditions and to align the DPA with the General Data Protection Regulation. The revised DPA is scheduled to enter into force on 1 September 2023.

Second, on 29 November 2020, the Swiss electorate rejected the Responsible Business Initiative, which aimed to legally oblige corporations based in Switzerland to incorporate respect for human rights and the environment into their business activities in Switzerland and abroad. A counter-proposal from the government, with similar objectives but less intrusive sanctions, has been adopted. Consequently, Swiss companies of public interest (ie, listed companies and companies in the financial sector supervised by the Swiss Financial Market Supervisory Authority), together with controlled companies in Switzerland and abroad have at least 500 FTEs on an annual average and exceed either total assets of 20 million Swiss francs or an annual turnover of 40 million Swiss francs, have increased their reporting and due diligence requirements to ensure that their business activities comply with human rights and international environmental standards.

These companies must report annually on certain non-financial matters (ESG reporting) including environmental concerns (eg, carbon dioxide emissions), social and employee concerns, human rights, and the fight against corruption.

An implementing ordinance on due diligence and transparency in relation to minerals and conflict-affected areas and child labour (DDTrO) has entered into effect on 1 January 2022 together with the new articles 964-bis et seq of the Swiss Code of Obligations. The new due diligence requirements will apply for the first time for the financial year beginning in 2023. Consequently, the first ESG reporting must be issued in 2024 with respect to financial year 2023. In that context, the Swiss government also published in March 2022 a draft ordinance which specifies the climate-related reporting obligations to be integrated into the general ESG report. The public consultation will end on 7 July 2022. The ordinance is expected to come into force at the beginning of the financial year 2023.

Third, on 25 August 2021, the Swiss government released a broad framework for a possible introduction of a screening regime of foreign direct investments. Under the contemplated investment control regime, acquiring control over Swiss companies by foreign investors shall be subject to review in certain industries if the companies provide non-substitutable services or if state entities in security-relevant areas are critically dependent upon them. It is still unclear which industries or sectors would be subject to notification and approval requirements in case of foreign private investors. Regardless of the sector, a notification and approval requirement is envisaged for any investments by foreign states or state-related actors. A draft bill was issued on 18 May 2022 for public consultation until 9 September 2022. After the consultation procedure, the draft bill shall be further debated by Swiss Parliament. The enactment of the Swiss investment control legislation is not expected before 2024.

Fourth, on 24 November 2021, the Swiss government published a preliminary draft for the revision of the Swiss Cartel Act and opened the consultation process. The main objective of the proposed revision is the modernization of Swiss merger control, by changing the current qualified market dominance test to the Significant Impediment to Effective Competition (SIEC) test. The merger control regulations is to be adapted to the standards already prevailing in the EU and the threshold for prohibiting a transaction should thus become lower.

In addition, the proposed revision clarifies the assessment of hardcore agreements by reintroducing the effects control of hardcore anticompetitive agreements. In reaction to the introduction by the *Gaba* Case of the concept of per se significance of certain agreements, a parliamentary motion requested to take into account both qualitative and quantitative criteria when assessing the significance of hardcore anticompetitive agreements.

The preliminary draft aims also to strengthen the civil enforcement of competition law and to modify the cartel administrative procedure. Indeed, the revision contemplates to extend the possibility of civil action to end customers suffering damages resulting from an unlawful agreement between undertakings.

The public consultation on the preliminary draft ended on 11 March 2022. Entry into force is expected in 2023 at the earliest.

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Foreign franchising in Turkey started in 1986 with McDonald's and it continues to grow to this day. There are no official statistics available; however, according to the Turkish Franchising Association, as of 2020, the country's franchise sector employs 250,000 personnel and offers an estimated market share of 43 billion dollars.

Turkey's geographic location and wide market appeal provide it with recognition among foreign franchisors all around the world. Franchising is likewise the preferred form of business in a vast range of industries in the country. The most common sectors for franchising are fast food, coffee chains, retail, cosmetics and transportation.

Turkey does not have a specific franchise regulation, and the majority of franchise agreements are freely executed. The market is generally quite hospitable to franchising, owing to the country's efforts to strengthen its economy, its approach to foreign investors and a dynamic, young population.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

There is the Turkish Franchising Association which was founded in 1991. Since its foundation, it has contributed to sectoral development, promotion of local brands, the country's integration into the international markets, and the protection of the rights of franchisees and franchisors.

The Turkish Franchising Association adopts the European Franchise Federation's European Code of Ethics for Franchising, however it has no force of law. The association accepts permanent and supporting members, but membership is not mandatory for franchisors and franchisees.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

Franchisors are free to form partnerships with any type of company. There are only a few forms of business entities under the Turkish Commercial Code No. 6102: joint-stock companies; limited liability companies; collective partnerships; *en commandite* partnerships; and partnerships limited by shares, joint ventures, branches or liaison offices.

The most common types of business entities in Turkey are joint-stock companies and limited liability companies. Tax obligations and other legal liability matters differ based on the nature of business entities.

Foreign franchisors do not have to establish a business entity in Turkey to grant franchise rights. However, foreign franchisors may establish a business entity of their choice or prefer to establish a branch in Turkey.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

The Turkish Commercial Code No. 6102 governs the formation of business entities, which must be registered with the trade registry of the city where the company has its headquarters, pursuant to the Trade Registry Regulation. The country's Ministry of Trade is the governing body of business entities.

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

Companies in Turkey must be registered at the trade registry. To do this, they need a company name, an address, one shareholder and an authorised person or entity. They must also draft and sign an article of association. There are tax and social security notification duties for newly established companies.

The requirements for forming and maintaining a business entity vary depending on its type. The most common business entities – joint-stock and limited liability companies – can be formed by a single shareholder. For limited liability companies, there is a maximum shareholder limit of 50. Shareholders of a business entity can be natural persons or business entities. Whereas joint-stock companies require a minimum capital of 50,000 Turkish lira (approximately US$3,260), the minimum capital required for forming limited liability companies is 10,000 Turkish lira (approximately US$650). Limited liability companies can pay their capital within 24 months; however, joint-stock companies must deposit 25 per cent of their capital during the formation process and pay the remainder within 24 months. Shares of joint-stock companies can be assigned through a written contract, while shares of limited liability companies can only be assigned through a written contract signed before a notary.

There are certain sectors – banking, insurance, financial leasing, etc – where it is required for a business entity to be formed as a joint-stock company. Only joint-stock companies can make a public offering.

Companies are required to hold an annual ordinary general assembly meeting within the first three months of formation, starting from the conclusion of each financial year, and submit the meeting minutes to the trade registry. They are also required to register any changes to the company structure.

Restrictions on foreign investors

6 | What restrictions apply to foreign business entities and foreign investment?

The main regulation in this instance is the Foreign Direct Investment Law No. 4875, which adopts equal treatment of foreign investors. Foreign investors can freely establish an entity, open a branch and acquire shares of an existing company – except in the case of certain regulated sectors, such as energy, telecommunication, banking, insurance and mass media – and conclude know-how or technical assistance agreements with domestic companies.

Since Decree No. 32 on the Protection of the Value of Turkish Currency, broad restrictions have come to force on the use of foreign currencies in transactions in Turkey. Therefore, it is important to determine the conditions for exemptions to these restrictions before conducting any transaction that includes a foreign currency.

Taxation

7 | What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

Turkish tax legislation can be classified under the three main categories of income tax, tax on expenditure and tax on wealth.

Individual and corporate incomes are subject to the income tax. Turkey taxes its residents on their worldwide income, whereas non-residents are taxed on Turkish-source earnings only. Individual income tax rates vary from 15 per cent to 40 per cent. The corporate income tax rate for 2022 is 23 per cent.

Taxes on expenditure consist of:

- Value added tax (VAT) – commercial, industrial, agricultural and independent professional goods and services, imported goods and services, and deliveries of goods and services as a result of other activities are all subject to VAT, which varies at the rates of 1 per cent, 8 per cent and 18 per cent.
- Special consumption tax (SCT) – petroleum products, automobiles and other vehicles, tobacco and tobacco products, alcoholic beverages and luxury products are subject to SCT, which is collected only once.
- Banking and insurance transaction tax – transactions and services performed by banks and insurance companies are subject to this tax.
- Stamp duty – applies to a wide range of documents including contracts, notes payable, capital contributions, letters of credit, letters of guarantee, financial statements and payrolls, varying from 0.189 per cent to 0.948 per cent depending on the value of the document.

There are three kinds of taxes on wealth:

- property tax;
- motor vehicles tax; and
- inheritance and gift tax.

In Turkey, tax on royalties paid to foreign entities must be withheld at the source, and royalty payments arising from franchise agreements are subject to a 20 per cent withholding tax. However, where the franchisor is a non-resident, withholding tax percentage may be reduced depending on the terms of the double taxation treaty between Turkey and the franchisor's country of origin.

Royalty payments are also subject to VAT if the franchising operations take place in Turkey. Where the franchisor is a non-resident, the franchisee must declare and pay the VAT. There is also stamp tax duty for signing a franchise agreement.

Labour and employment

8 | Are there any relevant labour and employment considerations for typical franchisors?

The main factors of general service agreements are service, payment and dependency, as regulated under the Turkish Code of Obligations No. 6098. Even though these three elements may be part of a franchise agreement, the franchisee is legally independent from the franchisor. The fact that the franchisee is dependent on the franchisor's instructions has indeed generated discussion in the doctrine on the nature of the employment relationship between the parties. However, the dominant opinion is that dependency on the franchisor's instructions does not affect the independency of the franchise, as potential risks belong to the franchisee who acts on its own behalf and account.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

In Turkey, trademarks and other intellectual property rights are mainly protected under the Industrial Property Law No. 6769 and the Law on Intellectual and Artistic Works No. 5846, alongside international agreements such as the Paris Convention and the Madrid Protocol.

Industrial Property Law No. 6769 stipulates that any sign (word, letter, number, design, logo, etc) that distinguishes the goods or services of a company from others may be registered as a trademark. This provides an exclusive right for the trademark holder to use the trademark on the registered goods and services for 10 years, which can be renewed for an unlimited number of times. Well-known trademarks within the scope of article 6-bis of the Paris Convention benefit from additional protection even if they are not registered. Trademark applications are submitted to the Turkish Patent and Trademark Office. There are no requirements regarding residency, headquarters or nationality for trademark holders. Turkey is also a member of the Madrid Protocol; therefore, national registration can be supplemented by an international registration via the World Intellectual Property Organization.

No proof of use is required for trademark registration; however, if the trademark holder does not use the trademark for five years following registration, their right may be forfeited and action may be taken to cancel the registration if the reason for non-use is not presented.

The application for the registration of an industrial design should also be filed with the Turkish Patent and Trademark Office. An industrial design can be registered if it is novel and has an individual character. Registered design protection starts from the application submission date and lasts for five years. It can be renewed for four consecutive periods of five years each, meaning that an industrial design can be registered for a total of 25 years. Unregistered industrial designs are protected under unfair competition provisions and the Industrial Property Law, provided that they are novel and individual in character, and that they are made available to the public for the first time in Turkey. Such protection starts from the moment the design is made available to the public and lasts for three years.

An invention is patentable in Turkey if it is novel, involves an inventive step and is capable of industrial application. Patent applications are filed with the Turkish Patent and Trademark Office, and protection starts from the date of the application. The term of protection is 20 years and is not renewable. The rights provided by a patent cannot be claimed against bona fide third parties, unless registered in due form.

Copyrights are mainly protected under the Law on Intellectual and Artistic Works No. 5846. Registration is not required to establish rights. Copyright protection is obtained automatically when the work is created and lasts for 70 years after the author's death. Cinematographic and musical works and video games – the latter which is categorised under cinematographic works by the State Council – must be registered with the General Directorate of Copyrights, which is part of the Ministry of Culture and Tourism, to exploit related rights and facilitate proof of ownership, but not for the creation of the rights themselves.

Turkish law provides an effective enforcement procedure for the protection of intellectual property rights. Once an infringement has been committed, sending a cease-and-desist letter from a notary public is usually the first step to an easier and faster relief for the intellectual property owner. Furthermore, it is possible to enforce intellectual property rights before the criminal law courts and civil law courts.

Protection against an infringement concerning an unregistered mark is offered under the unfair competition clauses of the Turkish Commercial Code No. 6102.

Outside the scope of copyrights pertaining to entities such as software, in Turkey know-hows are not protected by an explicit legislation. They are, however, protected under the unfair competition clauses of the Turkish Commercial Code No. 6102, and unfair competition acts are subject to imprisonment or monetary fines.

Real estate

10 What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

An individual or a legal entity may own property in the forms of full ownership, co-ownership or joint ownership. The land registry records are kept in an electronic centralised system known as the Land Registry and Cadastre Information System and in physical title books maintained by the relevant land registry directorate.

As a general practice, acquisition of real property by non-Turkish nationals in or nearby military zones and other security zones is not allowed. There are also some restrictions specific to the total land area individual, non-Turkish nationals may acquire. With some exceptions, acquisition of real property by Turkish legal entities with foreign shareholding requires the prior written consent of the relevant governorship where the real property is located, if the foreign shareholders own 50 per cent or more of the shares or have the privilege to appoint or dismiss the majority of the members of the board of directors of such company.

Lease relationships are governed under the provisions of the Turkish Code of Obligations No. 6098. There is no statutory format for lease agreements; however, the general practice is to have written lease agreements. Parties are entitled to conclude lease agreements with a fixed or indefinite term at their own discretion. If a lease agreement is concluded for a fixed term, it shall automatically terminate following the expiry of the term. However, a fixed-term agreement may turn into an indefinite-term agreement if the tenant continues to use the leased property following the expiry of the term without there being an explicit agreement between the tenant and the landlord. Where a residence or workplace is leased, the lease agreement shall be automatically extended for consecutive one-year periods, unless the tenant notifies the landlord of their intention to terminate the lease agreement at the end of the term with at least 15 calendar days' prior notice. The only exception to this general rule is the landlord's right to terminate any fixed-term lease agreement after 10 years of renewals by serving the tenant with a three-month prior written notice before the expiry of a subsequent lease term after the tenth year.

A lease agreement can be annotated with the records of relevant land registry directorate. Such annotation would grant the lessee the right to enforce the terms of the lease agreement against the future owner of the leased property.

It is more common for franchisors and franchisees in Turkey to lease than to purchase real estate for franchising operations, considering the conditions foreigners are expected to adhere to when purchasing real estate. There is no legislation regarding real estate specific to franchising. In practice, franchisors usually require franchisees to add in their lease agreements with the third-party landowner an extra clause where the property will be assigned to the franchisor upon the termination of the franchise agreement.

Competition law

11 What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

Under the country's main legislation governing competition – the Law on the Protection of Competition No. 4054 (the Competition Law) – vertical agreements apply to franchising.

The Competition Law's aim is:

- to inhibit agreements, decisions and practices that prevent, distort or restrict competition in the goods and service markets;
- to prevent the abuse of dominance by undertakings that dominate the market; and
- to ensure the protection of competition by making the necessary regulations and inspections.

Accordingly, inter-undertaking agreements, concerted practices, and such decisions and actions of associations that aim to, whether directly or indirectly, prevent, distort or restrict competition in a particular goods or service market, or that have or may cause such an effect, are illegal and prohibited.

Having said that, the Competition Law authorises the Turkish Competition Board to issue communiques that provide block exemption to certain agreement types bearing specific conditions. Vertical agreements are the primary agreements that are exempted from the main restrictions of competition rules. The conditions for this exemption are regulated under the Communiqué on Vertical Agreements (Communiqué No. 2002/2) issued by the Competition Board. The communique determines those matters that will be evaluated by the Competition Board with regard to block exemptions, and is accompanied by the Guidelines on Vertical Agreements.

Where the franchisor's market share is less than 30 per cent, the franchise agreement may benefit from block exemption if all other conditions are fulfilled. Where the franchisor's market share is more than 30 per cent, the franchise agreement can only benefit from individual exemption provided that all other conditions are fulfilled.

Pursuant to the Communiqué No. 2002/2, vertical agreements are considered to be outside the scope of block exemptions (hence, non-compliant with the Competition Law) if they mainly, but non-exhaustively, include:

- determination of resale prices;
- restriction on regions and customers;
- selective distribution systems;
- non-compete obligations;
- single branding restrictions; or
- exclusive supply provisions.

Under Communiqué No. 2002/2, the franchisor is prohibited from fixing resale prices. However, non-binding price recommendation and determination of maximum prices is permissible.

As a rule, to benefit from block exemption, the duration of a non-compete clause cannot exceed five years. However, the non-compete obligation in a franchise agreement may be determined for a term longer than five years so long as this is deemed reasonable. Additionally, a post-term non-complete obligation can be imposed, provided that:

- it does not exceed one year after the expiry of the franchise agreement;
- the prohibition is for goods and services subject to the agreement and limited to the facility or land where franchise operations took place during the agreement; and
- it is considered to be necessary for the protection the transferred know-how.

Online sales are evaluated as passive sales and, therefore, general prohibition of online sales is considered a hardcore restriction pursuant to the Communiqué No. 2002/2.

The Turkish Competition Board is the authority that enforces competition rules in the franchising sector. Violation of competition law may lead to the invalidation of the franchising agreement and may result in an administrative fine of up to 10 per cent of the annual gross income (in practice, applied as income generated in Turkey only) at the end of the fiscal year.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

There is no legal definition of franchise under Turkish legislation, due to a lack of specific regulation. Even so, the Turkish Franchising Association defines franchise as:

> *The franchisee undertaking the right and obligation to use the franchisor's trade name, service trademark, know-how, business and technical methods, system and other industrial or intellectual property rights in return for a direct or indirect price, with the commercial and technical support it will receive continuously within the term and scope of the written franchise agreement made between the parties.*

And according to the Communiqué No. 2002/2:

> *Franchise agreements contain licences related to know-how and intellectual property rights such as trademarks and signs, which will be used in the distribution of goods or services. The franchisor usually provides commercial and technical assistance to the franchisee during the term of the agreement. Licences and assistances are integral parts of the business method in the franchise package. The franchisee pays the franchisor a franchise fee in return for these services. Franchising allows the franchisor to establish a uniform distribution network for their products with a limited investment.*

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

The offer and sale of franchises are not controlled by any law or government agency in Turkey.

Franchising agreements are considered as sui generis agreements and are executed freely by the parties on condition that they are in compliance with the general legal principles and competition rules. Different laws may apply to different subjects (and sectors) related to franchising. In general, the Turkish Code of Obligations No. 6098, the Turkish Commercial Code No. 6102, the Law on the Protection of Competition No. 4054 and the Industrial Property Law No. 6769 apply to offer and sale of franchises.

There are no exemptions to or exclusions from these laws, because a specifically governed franchise law does not exist in Turkey.

Principal requirements

14 | What are the principal requirements governing the offer and sale of franchises under the relevant laws?

There are no principal requirements governing the offer and sale of franchises in Turkey.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

No. Having said that, the Turkish Franchising Association adopts the European Franchise Federation's European Code of Ethics for Franchising. By their Principle of Honesty, franchisor must have successfully run its business for a reasonable period of time and at least in one example business; and by their Principle of Clarity, the franchisor should state how long they have been selling their name right with the franchising system in their field of activity, and the last five year's work experience of the franchisor's executives. Additionally, the Turkish Franchising Association, in its 2022 Franchising Guide, references American Associated of Franchisees & Dealers' rules regarding franchisor eligibility. However, these Principles and Guides do not have any force of law.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

No. Having said that, the Turkish Franchising Association adopts the European Franchise Federation's European Code of Ethics for Franchising and by their Principle of Honesty, a franchisor should select and accept an individual franchisee, upon reasonable investigation, by their possession of the basic skills, education, personal qualities and financial resources sufficient to carry on the franchise business. However, this principle does not have any force of law.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

There are no pre-contractual disclosure requirements related to franchising in Turkey.

Pre-contractual disclosure – content

18 | What information is the disclosure document required or advised to contain?

There are no pre-contractual disclosure requirements related to franchising in Turkey.

Pre-sale disclosure to sub-franchisees

19 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

There are no pre-sale disclosure requirements related to sub-franchising in Turkey.

Due diligence

20 What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

The franchising parties are under no specific due diligence obligations. However, according to the general principles of the Turkish Civil Code, a pre-contractual trusting relationship requires the parties to diligently disclose any information material to the business. All facts material to the franchisee's decision to enter into the franchising agreement must be disclosed by the franchisor.

Failure to disclose – enforcement and remedies

21 What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

There are no disclosure requirements related to franchising in Turkey.

Pursuant to the general principles of the Turkish Civil Code and to the culpa in contrahendo principle under the Turkish Code of Obligations, parties are responsible to each other and act trustworthy until the signing, which includes disclosing facts and not providing false information. If acting contrary to these principles shall cause a damage to a party, such as making an investment or expenses, or both, these damages shall be compensated.

Additionally, pursuant to the Turkish Code of Obligations, if one of the parties deliberately deceives the other parties of a contract, this injures their willpower and will result in invalidity of the contract upon the claim by the deceived, within one year of the date of learning about the deceit. Additionally, the deceiving party will be responsible for providing compensation for damages.

The damages are generally calculated based on negative interest and positive interest, that is, based on the difference between the wealth of the franchisee as a result of the injury and the wealth they would dispose of without the damaging event (missing opportunities of executing other franchising agreements). Either way, the franchisee would need to prove the damage is suffered as a result of the franchisor's failure to provide required or correct information.

Failure to disclose – apportionment of liability

22 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

There are no disclosure requirements related to franchising in Turkey.

In principle, the damage claims can be made to the parties of a contract and therefore, unless agreed otherwise, the franchisor would not be liable for the sub-franchisor's acts regarding disclosure violations.

The liability of officers and directors is limited if the entity is formed as a joint-stock or limited liability company. These executives would be able to be held liable in cases of intentional or negligent breach of duty of care. For damages caused by employees in the performance of their work, liability is generally borne by their employers. For infringement of criminal provisions, (eg, unfair competition clauses), officers, directors and employees may be liable directly.

General legal principles and codes of conduct

23 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

Pursuant to the Turkish Code of Obligations, for a contractual relationship to be established, the main elements of an agreement – that is, factors that would affect the other party's decision to enter into the agreement – shall be disclosed and the parties' wills must be coherent and compatible.

Pursuant to the principle of 'culpa in contrahendo', a party's reliance on the relation arising from contractual negotiation is protected by law, and the concerning party shall have the right to claims of damages related to it.

There are no formal requirements that apply to franchising agreements; either written or oral franchising agreements are binding and valid. However, pursuant to the Industrial Property Law, legal transactions related to trademark and patent must be in written form to be valid, and as franchising agreements mainly include trademark and patent licence clauses, they are executed in written form.

If the franchise agreement includes standardised terms that are used in agreements with other franchisees, the franchisor is obligated to inform the franchisee of such terms. These terms cannot be unilaterally changed by the franchisor, especially to the disadvantage of the franchisee.

Under the Turkish Civil Code, every individual must exercise their rights and fulfil their obligations according to the principles of good faith.

Fraudulent sale

24 What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

Pursuant to the Turkish Code of Obligations, if a party has entered into a contractual relationship as a result of fraudulent acts carried out by the other party, they shall not be bound by the contract.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There are no specific laws regulating the ongoing relationship between franchisor and franchisee. The terms of the franchising agreement usually define such a relationship. For the cases where the relationship is not determined in the franchising agreement, the general rules of the Turkish Civil Code, the Code of Obligations and the Commercial Code apply.

Operational compliance

26 What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

Franchising agreements usually include clauses granting the franchisor the right to inspect and audit the franchisee's books and records for compliance with operational obligations. It is more common for foreign franchisors to require audits on technology and reports (eg, financial, operational, sales and expenses) than physical inspection and audit. There are also practices where franchisors have key employees working with the franchisee to ensure compliance.

Amendment of operational terms

27 May the franchisor unilaterally change operational terms and standards during the franchise relationship?

The franchisor may reserve the right to change operational terms and standards during the franchise relationship. However, under the Turkish Code of Obligations, a party cannot unilaterally change any standard term during a contractual relationship, especially if these changes place the other party at a disadvantage.

Policy affecting franchise relations

28 Do other government or trade association policies affect the franchise relationship?

Not directly.

Termination by franchisor

29 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

There are no specific termination conditions regarding franchise relationships. However, under the general principles of law, unless determined otherwise in the franchising agreement, definite-term franchising agreements can only be terminated with a just cause or in return for compensation, while indefinite-term franchising agreements can be terminated at any time with a termination notice.

Termination by franchisee

30 In what circumstances may a franchisee terminate a franchise relationship?

There are no specific termination conditions regarding franchise relationships. However, under the general principles of law, unless determined otherwise in the franchising agreement, definite-term franchising agreements can only be terminated with a just cause or in return for compensation, while indefinite-term franchising agreements can be terminated at any time with a termination notice.

Renewal

31 How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

There are no specific requirements concerning renewals of franchise agreements in Turkey.

Refusal to renew

32 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

There are no specific requirements concerning renewals of franchise agreements in Turkey. Principally, pursuant to the contractual freedom of the parties, parties are free to refuse to renew an agreement, without any justification.

Transfer restrictions

33 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Franchising agreements are principally transferable, unless otherwise agreed by the parties.

Fees

34 Are there laws or regulations affecting the nature, amount or payment of fees?

No. The parties of a franchise agreement are free to determine such conditions.

Apart from common franchise fees, the 'portfolio compensation' should be paid to franchisees where claimed. The portfolio compensation is regulated under the Turkish Commercial Code for commercial agency agreements, where the agent has the right to compensation after the relationship expires or is terminated but the principal continues to benefit from the customer base and market reputation developed by the agent.

The Supreme Court and the Turkish doctrine agree that certain provisions regarding commercial agency agreements, including portfolio compensation, apply to franchise agreements. The portfolio compensation, therefore, shall be paid to franchisees; however, the compensation cannot exceed the average value of the franchise fees or limit the other party's liability arising from gross fault or gross negligence.

Usury

35 Are there restrictions on the amount of interest that can be charged on overdue payments?

Pursuant to the Turkish Commercial Code No. 6102, commercial business interest rates can be determined freely by the parties. Where there is no provision determining the interest rate for overdue payments, the Law on Legal Interest and Default Interest No. 3095 shall apply, according to which, where there is no rate determined by the agreement, the default legal interest rate will be 9 per cent per annum. There is also an option to apply the rate determined by the Central Bank of the Republic of Turkey, if this rate is higher than the legal interest, which is 15.75 per cent at the time of writing.

For overdue payments in foreign currency, the Law on Legal Interest and Default Interest No. 3095 regulates that in cases where a higher contractual or default interest is not agreed on, the highest interest rate paid by the state banks to a one-year deposit account in that currency is recognised as the interest rate of the foreign currency debt.

Foreign exchange controls

36 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Yes. The common practice is to determine a penalty in case of a breach of confidentiality. However, in case of a dispute, penalties exceeding the damage as a result of a breach may be reduced.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

There is a general principle governed under the Turkish Civil Code No. 4721 which stipulates that every person must act in good faith when exercising their rights and performing their obligations. This principle may apply to the bargaining process in circumstances where the more powerful party (often franchisors) must act in good faith while bargaining with the less powerful party (often franchisees). Moreover, in principle, Turkish law does not protect the party who is acting maliciously.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

No.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

Pursuant to the Law on the Mandatory Use of the Turkish Language in Commercial Enterprises No. 805, agreements between commercial enterprises must be in Turkish. If there is a foreign entity involved, the agreement can include another language, provided that the Turkish version prevails. Even though agreements executed in another language are not deemed to be invalid, it is recommended to draft agreements bilingually to avoid any conflicts arising from claims against unclear terms and conditions.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

Common franchise agreements include clauses on grant of rights, exclusivity, right to sub-franchise, term and renewal, fees and taxes, operations, territory, obligations, advertisement, marketing, audits and reports, intellectual property, confidentiality, non-competition, management and ownership, transfers, termination and remedies, indemnification, governing law and dispute resolution.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Under the Turkish legal system, courts are either categorised as judicial or administrative. Judicial courts, which constitute the broadest section of the Turkish judicial system, are subdivided into two branches consisting of civil courts and criminal courts, whereas administrative courts are sub-divided into administrative courts and tax courts.

Turkey's judicial system has a multipartite structure. All courts consist of three levels: first instance courts; district courts; and supreme courts.

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A franchise dispute may be subject to arbitration if mutually agreed upon by the parties, and the mediation application is mandatory for commercial disputes that are related to monetary claims. Voluntary mediation is also available as an alternative dispute resolution method for the parties of franchise agreements.

Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

The parties of an agreement are free to choose the governing law of the franchise agreement. However, pursuant to the International Private and Procedural Law No. 5718, certain mandatory laws will apply notwithstanding the choice of jurisdiction. The same law requires that demands concerning prevention of competition are subject to the regulations of the state whose market is directly affected by such prevention (ie, Turkish competition legislation applies to franchising agreements taking effect in Turkey).

Arbitration – advantages for franchisors

44 | What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

In Turkey, in large commercial disputes, especially where one party is foreign, the most favoured manner of resolution is arbitration. For foreign franchisors, the principal advantages of arbitration are: the procedures are more flexible; the process is faster, costs less than court proceedings and remains confidential; and arbitrators can be selected among experts. The principal disadvantage could be that, in practice, arbitration costs more than litigation where the disputed amount is high.

On 11 March 2021, Turkey ratified the United Nations Convention on International Settlement Agreements Resulting from Mediation (the Singapore Convention). As an alternative dispute resolution, this allows

commercial international mediation settlement agreements to be enforced in member states without the need for full court proceeding, which are more time-consuming and costly. It also promotes mediation as an alternative dispute resolution measure in international commercial disputes and fills the void for international mediation within the international trade law.

Lastly, in Turkey, the mediation application is mandatory for commercial disputes which are related to monetary claims before filing commercial lawsuits. In addition to mandatory mediation, voluntary mediation is also regulated under Turkish law, which offers a fast-paced and economically advantageous resolution to contractual disputes or other private law conflicts of any type.

National treatment

45 In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Foreign franchisors are not treated differently from domestic franchisors. Although there are legal conditions – such as owning an immovable property, owning 100 per cent shares in certain sectors or use of foreign currency in specific situations – that may apply to foreign franchisors, especially if they have no presence in Turkey.

UPDATE AND TRENDS

Legal and other current developments

46 Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

There are no proposals for new legislation or regulation, and no proposals for revising existing legislation and regulation.

In November 2021, the Turkish Competition Authority lowered the market share threshold that applies to vertical block exemptions with Communiqué No. 2021/4 on the Amendments on the Block Exemption Communiqué on Vertical Agreements No. 2002/2. Following this change, vertical block exemptions will apply on the condition that the market share held by the supplier does not exceed 30 per cent of the relevant market, instead of the previous 40 per cent.

United Kingdom

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MARKET OVERVIEW

Franchising in the market

1 How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

The franchise sector in the United Kingdom continues to grow. According to the latest franchise industry survey published in 2018 by NatWest Bank and the British Franchise Association (BFA), it is estimated that the sector contributed in excess of £17 billion to the UK economy, an increase of £2 billion since the survey was last undertaken in 2015. In that time, the number of franchise units operating has increased by almost 25 per cent. This is a trend that has almost certainly continued since then.

Given its strong economy and relatively benign regulatory environment, coupled with the fact that English is widely spoken throughout the rest of the world, the United Kingdom is internationally recognised as a popular destination for franchisors from outside of the United Kingdom looking to expand their overseas operations.

There is no doubt that, despite the covid-19 pandemic, the food and beverage market continues to be a buoyant sector within the franchising space, particularly given the appetite from overseas brands to expand into the United Kingdom. In addition, given the United Kingdom's ageing and health-conscious population, the number of both domiciliary care and health and fitness franchises continues to rise.

Given the relatively uncertain global economic landscape, the success of the franchise industry is bound in with the banks' ability and willingness to lend. However, the banks in the United Kingdom look more favourably on lending to franchised businesses as opposed to independent businesses.

Associations

2 Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The BFA is the main voluntary self-regulatory body in the franchise sector. The aim of the BFA is to promote ethical franchising in the United Kingdom. The BFA also acts as a spokesperson for the interests of the sector both on a domestic and international level. It has, for many years, successfully argued that the regulation of franchising through legislation is not necessary and would do more harm to the franchising sector than good.

Its members agree to be bound by the Code of Ethics that, at its core, promotes fair dealing between the franchisor and the franchisee from the outset of the franchising relationship through to its termination.

BUSINESS OVERVIEW

Types of vehicle

3 What forms of business entities are relevant to the typical franchisor?

In the United Kingdom, it is usual for a franchisor to operate as a limited liability company. This is also true for most substantial businesses operating outside of the franchising sector. A company is a separate legal entity, distinct from its directors and shareholders, which enables it to enter into contracts in its own name.

A franchisor may also operate as a limited liability partnership (LLP). An LLP combines the flexible structure of a partnership with the benefits of limited liability for its members. Like a company, an LLP has a legal personality separate from that of its members, one of which must be a natural person.

The franchisor may also operate as a sole trader or as an unlimited partnership. Unlike an LLP, an unlimited partnership is not a distinct legal entity from its partners and, therefore, its partners are jointly and severally responsible for the business's debts and liabilities.

Regulation of business formation

4 What laws and agencies govern the formation of business entities?

Companies are formed under and governed by the Companies Act 2006, and LLPs are formed under and governed by the Limited Liability Partnership Act 2000. Unlimited partnerships are governed by the Partnership Act 1890.

Requirements for forming a business

5 Provide an overview of the requirements for forming and maintaining a business entity.

Companies must be registered at Companies House. In order to incorporate a company, those looking to set one up will need to pick a suitable company name, identify an address that will act as the registered office address of the company, have at least one director that is a natural person and have at least one shareholder. Companies also need to adopt a set of articles of association, which are the written rules that will govern the running of the company and relationship between the shareholders. Companies generally use standard model articles, but these can be tailored to the company's structure or business. Once incorporated, Companies House will issue an incorporation certificate and company number. A set of company books must be maintained that detail certain information about the company and should be updated to reflect any changes. Certain changes and information will need to be filed at Companies House, including confirmation statements (detailing the shareholders) and company accounts. When incorporating,

companies are required to identify and record the people who own or control the company, known as People with Significant Control (PSC). Information about a company's PSC is kept within a central public register at Companies House and should be updated to reflect any changes to the PSC. The PSC register helps to increase transparency over who owns and controls UK companies.

Limited liability partnerships must also be registered at Companies House. They are also required to file annual confirmation statements, annual accounts and update Companies House of any changes to its membership or registered office address. There is no specific requirement within the Limited Liability Partnerships Act 2000 for an LLP to have an LLP agreement. In the absence of such an agreement, the governance of the LLP is detailed in the default provisions set out in the Limited Liability Partnerships Regulations 2001. It is unlikely that the default provisions set out in those Regulations would be adequate for the governance of most modern LLPs. LLPs are also required to provide information about its PSC to Companies House.

Partnerships are not registered at Companies House and are deemed to have been formed once they satisfy the definition of a partnership under the Partnership Act 1890. The governance of a partnership is detailed in the Act, except where the provisions of the Act have been amended by any partnership agreement entered into between the partners. As with LLPs, it is unlikely that the provisions set out in the Act would be adequate for the governance of most modern partnerships.

Restrictions on foreign investors

6 What restrictions apply to foreign business entities and foreign investment?

The United Kingdom is a popular destination for foreign businesses seeking to expand overseas. Business regulation in the United Kingdom is relatively light-touch, as evidenced by its approach to franchising.

The Department for International Trade promotes foreign businesses trading in the United Kingdom and encourages investment from overseas. In general, there are no restrictions on ownership by foreigners of UK assets and foreign businesses and individuals are allowed to be both shareholders and directors in UK companies. UK immigration laws highlight how foreign investment is encouraged, allowing individuals from overseas to apply for visas based on their investment into certain UK companies. Of course, since Brexit, citizens of EU member states no longer have the automatic right to live and work in the United Kingdom, which may make franchising more complicated in some instances.

Taxation

7 What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

UK-resident companies are required to pay corporation tax on their worldwide profits. Companies are taxed based upon their accounting reference period and can choose when their accounting period ends. Companies are required to file their annual accounts with a tax return with Her Majesty's Revenue and Customs (HMRC) within 12 months of the accounting reference period. The accounts must also be filed with Companies House (there is reduced disclosure for smaller companies) and, therefore, the accounts become a matter of public record.

A non-resident company will not be liable to tax merely as a result of trading with UK businesses. However, when a non-resident company is trading through a permanent establishment in the United Kingdom (or is controlled from the United Kingdom), it will be subject to corporation tax on the profits made by that permanent establishment. Any corporation tax suffered in the United Kingdom by a non-resident company may be reduced or eliminated under a relevant double tax treaty (DTT). In some cases, accounts from the permanent establishment are also required to be filed at Companies House.

Where a franchisor establishes a UK-resident subsidiary, that company will be taxed in its own right, as set out above.

LLPs are not subject to corporation tax, but members, as with partners in a partnership, will be taxed individually.

The tax year for individuals ends on 5 April and an individual is taxed on the profits of his or her accounts during that tax year. He or she can choose when his or her accounting year ends. The accounts are required to be filed with a tax return with HMRC on or before 31 January following the end of the tax year.

Individuals are now subject to a statutory residency test that determines if that person is resident in the United Kingdom or not. The test is based on both the number of days of physical location in the United Kingdom and some further connection factors.

An individual resident in the United Kingdom is taxed on his or her worldwide profits and capital gains (although in some cases resident but non-domiciled individuals may only be taxed on profits remitted to the United Kingdom). As a general rule, individuals who are non-resident in the United Kingdom will be liable to income tax on profits arising in the United Kingdom. However, the DTT with the country in which they reside will determine which country has the taxing rights and any income tax suffered in the United Kingdom is likely to be relievable against tax in their domestic country in accordance with the DTT.

A non-resident company or individual generating royalties, licence fees and interest in the United Kingdom may suffer a withholding tax on that income retained and paid to HMRC by the paying company. The DTT between the United Kingdom and the company's or individual's country of residence may reduce the rate of the withholding tax. The non-resident may be able to recover this withholding tax against their own domestic tax.

The franchise agreement therefore should stipulate whether the franchisee is obliged to gross up any payment or cooperate with the franchisor in recovering any sums paid to HMRC (where appropriate) under any DTT.

Labour and employment

8 Are there any relevant labour and employment considerations for typical franchisors?

There are a number of employment law duties and discrimination protections that franchisors must be mindful of (some are 'time served' protections and others are 'day one' employee rights).

The employment disputes environment had become relatively benign because, in 2013, the government introduced a fee to be paid to progress an employment claim in the tribunal system. However, this fee was quashed by the Supreme Court in 2017 and the number of claims has risen sharply as a consequence.

In addition to this, there are a range of business immigration controls for franchisors to consider for any employees of the franchisor following the end of free movement post-Brexit. Employers must now sponsor individuals to work in the United Kingdom if they are not 'settled workers' or do not have some other immigration permission allowing them to work in the United Kingdom. EEA and Swiss nationals (and their eligible family members) who were already in the United Kingdom before 11pm on 31 December 2020 must apply for 'settled' or 'pre-settled' status under the EU Settlement Scheme by 30 June 2021 and that application must be granted, or they will be in the United Kingdom illegally from 1 July 2021. EEA nationals who arrive in the United Kingdom after 11pm on 31 December 2020 will need to be sponsored under the Skilled Worker visa, or the Intra-Company or Temporary Worker routes unless they can evidence that they have another type of immigration permission enabling them to work in the United Kingdom.

Franchisors are not considered to be employers or joint employers of franchisees' employees. However, in the context of franchisors and franchisees, employment status has been a fast-moving area of case law development in recent years and it is entirely possible, if the relationship is not structured and documented correctly, for a relationship described as franchisor and franchisee to be deemed to be one of employer and employee or engaged worker. The Employment Appeal Tribunal recently looked that the concept of 'personal service' as a hallmark of employee or worker status within a franchising context and held that there was a genuine right of substitution that was inconsistent with providing a personal service, and as such, the franchisees were held to be genuine self-employed contractors.

There have also been legal challenges in the use and perceived abuse of zero hours contracts, whereby workers are not entitled to any specified number of hours' work.

Intellectual property

9 | How are trademarks and other intellectual property and know-how protected?

Trademarks in relation to goods or services can be registered at the Intellectual Property Office (IPO) as a UK mark or at the European Union Intellectual Property Office as a community mark.

Anyone considering franchising in the United Kingdom should ensure that its trademarks are registerable, as the registration of the trademark normally gives the owner the exclusive right to prevent others from using the mark and there is a market expectation that any trademark being licensed is registered or at the very least in the process of being registered.

The registration of trademarks at the IPO is a relatively simple and inexpensive process so long as no opposition to the registration is lodged.

As a result of Brexit, with effect from 1 January 2021, the IPO will create a comparable independent UK trademark for every registered EU trademark, which will have same legal status as if registered under UK law. The UK trademark will keep the original EU trademark filing date.

Where franchisors have applications pending for EU trademarks as at 1 January 2021, although they will not automatically obtain a comparable UK trademark, they will have nine months to apply in the United Kingdom for the same protection. A fee will be payable, and the application will be examined and published in the usual way.

Where a franchisor has either not yet registered or cannot register a trademark, the franchisor may have a claim for 'passing off' if a competitor imitates the goods or services it offers in such a way that the public believes them to be those of the franchisor. A claim will be successful if there is goodwill and a reputation attached to the goods or services it offers, and the franchisor has suffered a loss.

Know-how relating to the franchise system will invariably be detailed in the system's manual. It cannot be protected by registration and is, therefore, protected through the franchise agreement. The franchise agreement will contain a requirement on the franchisee to keep any know-how and other confidential information belonging to the franchisor confidential both during and after the currency of the franchise agreement.

Real estate

10 | What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

Property law in England and Wales is based on the common law system, and as such, proprietary interests in land derive from either freehold (where the freeholder owns the property outright and is free to dispose of it) or leasehold (where the leaseholder is entitled to occupy the premises for an agreed period subject to the terms of the lease including an obligation to pay rent to the landlord) interests. How the property from which the franchise business operates is occupied usually depends on the franchisor's business model and it is crucial that the agreements to occupy any premises dovetail with the franchise agreement.

It is common for a franchisee to take a direct lease, in which case the franchisor may require step-in rights, which can usually be exercised (depending on the terms of those step-in rights) in the event of default by the franchisee of the terms of the lease or termination of the franchise agreement. These would allow the franchisor to take on the franchisee's rights and obligations under the lease.

Where the premises are critical to the success of the franchise, the franchisor may take a head-lease and grant a sub-lease to its franchisee. This allows the franchisor to have more control over the premises, but comes with an increased financial risk.

If the franchisor owns the freehold itself and grants a direct lease to its franchisee or is granting a sub-lease to the franchisee, it is crucial that the security of tenure provisions otherwise conferred by the Landlord and Tenant Act 1954 are excluded, so that the franchisor retains an element of control over the occupation of the premises, otherwise the franchisee tenant can benefit from a right to occupy the premises after expiry of the lease, and even have a right to request a new lease. This legislation does not apply in Scotland, which has a different real estate system.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

Chapter I of the Competition Act 1998 prohibits agreements that may affect trade within the United Kingdom, and have as their object or effect the prevention, restriction or distortion of competition within the United Kingdom. In practice, post-Brexit, franchisors operating within the United Kingdom initially saw no substantive change to the competition law regime, as Chapter I was modelled on article 101 of the Treaty of the Functioning of the European Union. Although article 101 no longer applies in the United Kingdom, it will apply to UK businesses that enter into agreements that have an effect in the European Union.

Whether a franchise agreement falls within the scope of Chapter I of the Competition Act 1998 will depend on a number of factors, including the parties' relevant market share. In practice, most franchisors draft their agreements so that they benefit from the EU's Vertical Block Exemption Regulation (the Block Exemption Regulation). The Block Exemption Regulation was retained in UK law post-Brexit. With effect from 1 June 2022 the Block Exemption Regulation will cease to have effect and will be replaced by the UK's Vertical Agreements Block Exemption Order. If a franchise agreement falls within the terms of the relevant block exemption, it will be exempt under Chapter I of the Competition Act 1998. For example, a five-year initial term is common in franchise agreements, as they typically contain in-term non-compete restrictions, which, if longer than a five-year period, will not benefit from the relevant block exemption.

Furthermore, any hardcore restrictions contained in the franchise agreement will lead to the exclusion of the franchise agreement from the scope of the relevant block exemption. These include an obligation on franchisees to sell goods or services for a minimum price (resale price maintenance) or restrictions on franchisees from responding to unsolicited requests from customers to provide goods or services (passive sales) outside of an agreed territory. Restrictions on passive sales also prevent franchisors from prohibiting franchisees from operating their

own websites, but not from requiring that such websites meet certain specifications.

Competition issues are regulated domestically by the Competition and Markets Authority. Sanctions include financial penalties or the voiding of provisions within the franchise agreement.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

There is no legal definition of franchising under UK law and as such is an indication of the absence of regulation in the sector. However, the British Franchise Association's (BFA) Code of Ethics adopts its definition of franchising from the European Code of Ethics for Franchising and describes franchising as:

> *A system of marketing goods and/or services and/or technology which is based upon a close and ongoing collaboration between legally and financially separate and independent undertakings, the franchisor and its individual franchisees, whereby the franchisor grants to its individual franchisees the right, and imposes the obligation, to conduct a business in accordance with the franchisor's concept.*
>
> *In exchange for fees or other financial consideration, the franchisor grants a franchisee the right to use the franchisor's trade name, know-how, technology and systems and other intellectual property rights, supported by continuing provision of commercial and technical assistance, within the framework of a written franchise agreement.*

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

There are no government agencies or specific legislation that regulate the offer and sale of franchises.

However, the BFA Code of Ethics places obligations on member franchisors in relation to the offer and sale of franchisees. Membership of the BFA is voluntary.

Franchising arrangements may be subject to the Trading Schemes Act 1996 and the Trading Schemes Regulations 1997, which were enacted to tighten up the existing legislation regulating pyramid selling through trading schemes, namely the Fair Trading Act 1973. Franchisors must be mindful of the legislation owing to its broad drafting.

The Trading Schemes Regulations 1997 (the Regulations) do not place a prohibition on trading schemes. However, in the event that the franchising relationship is considered a trading scheme, then the Regulations place obligations on franchisors in relation to advertising and can impose contractual requirements, including a cooling-off period. These requirements would make franchising an unattractive business model. Therefore, in practice, franchise networks in the United Kingdom are structured to ensure that a franchisor is exempt from the legislation.

A franchisor can ensure that it is exempt from the legislation by either operating as a single tier (namely by having one level of franchisee) or by being, and making certain that all the franchisees (and all other relevant participants) are, value added tax-registered.

If the franchisor is unable to benefit from one of the exemptions and subsequently breaches the legislation, it may become subject to criminal sanctions or the franchisor may find itself subject to civil claims from a franchisee for breach of its statutory duties. In addition, any obligation on the franchisee to pay fees to the franchisor will be unenforceable.

Principal requirements

14 | What are the principal requirements governing the offer and sale of franchises under the relevant laws?

Where franchisors are members of the BFA, they are required under the terms of their membership, but not as a matter of law, to comply with the Code of Ethics to ensure that all advertising for the recruitment of franchisees is free of ambiguity and misleading statements.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

There are no specific laws or regulations.

The BFA Code of Ethics requires that, prior to franchising, the franchisor has operated at least one pilot unit, has the right to use its brand, and provides its franchisees with initial training and continuing assistance.

It is important to note that where, as part of the process of offering and subsequently awarding the franchise, the franchisor requests that the franchisee pay a deposit, the BFA Code of Ethics stipulates that the deposit must be refundable, subject to the franchisor retaining any quantifiable directly related expenses incurred by it and that the terms upon which any deposit is taken are set out in writing.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

No, there are no such laws or regulations.

However, the BFA Code of Ethics states that the franchisor may only select and accept franchisees who appear to possess the basic skills, education, personal qualities and financial resources to carry on the franchise business.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

There is no legal requirement to disclose information to a prospective franchisee and as such there are no procedural formalities.

The BFA Code of Ethics requires that franchisees are provided with an up-to-date copy of the Code, along with a full and accurate written disclosure of all information material to the franchise relationship within a reasonable time prior to execution of the franchise agreement.

Even where a franchisor is not a member of the BFA, it should consider preparing some form of disclosure document to give to prospective franchisees to enable it to give accurate and consistent responses to due diligence enquiries.

Pre-contractual disclosure – content

18 | What information is the disclosure document required or advised to contain?

Although there is no legal requirement as to what information is disclosed to a prospective franchisee, the BFA Code of Ethics sets out the type of information that its members are required to disclose. Even where a franchisor is not a member of the BFA, it should consider preparing some form of disclosure document providing similar information.

Under the BFA Code of Ethics, franchisors must give prospective franchisees all information that they require to be able to make a properly informed decision about whether to invest in a franchise. This will include:

- the financial status of the franchisor;
- how long the franchisor has been operating and franchising;
- information about the franchise's directors and key individuals within the franchise;
- a description of the franchise's business model;
- proper verifiable financial forecasts of the franchise model;
- information about the performance of the network;
- details of franchisees;
- details of any 'purchasing incentives' or commissions; and
- a copy of the franchise agreement.

Pre-sale disclosure to sub-franchisees

19 | In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

There is no legal requirement to disclose information to a prospective sub-franchisee.

Where the sub-franchisor is a member of the BFA, it would be obliged under the Code of Ethics to provide franchisees with a full and accurate written disclosure of all information material to the franchise relationship within a reasonable time prior to execution of the franchise agreement. This would include, disclosure of the fact that the sub-franchisor is licensed by the franchisor to grant franchises and to explain clearly its relationship with the franchisor.

Due diligence

20 | What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

The franchisor should satisfy itself that franchisees are of suitable character, and have the necessary skills base and (if applicable) qualifications to operate the franchise. Franchisors should also ensure that franchisees have sufficient funding to both open and operate the franchise. It is important to ensure that the individuals who will be operating the franchise have the legal right to reside in the United Kingdom throughout the term of the franchise agreement.

A franchisee should review in detail any disclosure document provided by the franchisor, to ensure an understanding of the costs involved in running the franchise and the expected financial returns. A franchisee should check that the franchisor has the right to licence the relevant trademarks to the franchisee, and it is market practice for a franchisee to instruct a lawyer to prepare a report on the franchise agreement highlighting its key commercial terms and any issues that should be raised with the franchisor. A franchisee should enquire about the number of franchises within the network, including the number of franchise failures, and speak to existing franchisees to understand their views on operating within the network.

Failure to disclose – enforcement and remedies

21 | What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

A franchisor could find itself the subject of a claim for misrepresentation from a franchisee. Such a claim would arise if the franchisor were to make an untrue statement of fact that induces the franchisee to enter into a franchise agreement. This would typically be some form of earnings claim with little basis in fact. Depending on the circumstances in which the statement is made, the franchisor may then be subject to a claim for one or more of innocent, negligent or fraudulent misrepresentation. Such statement can be made either orally or in writing. In the case of a successful claim for misrepresentation, depending on the facts, the franchisee may be able to rescind the agreement or, where it has suffered loss, claim for damages, or both. If the misrepresentation was innocent, then the court may rescind the agreement or award damages in lieu of recession, but not both. In the case of fraudulent or negligent misrepresentation, a court can award damages and rescind the agreement. If an agreement is rescinded, the parties are restored to the position in which they would have been had the agreement never been entered into.

The franchisor will invariably insert provisions into the franchise agreement to restrict or exclude liability for misrepresentation. The effectiveness of such clauses is subject to both statute and common law. Where a clause seeks to limit liability for misrepresentation, it would be subject to the test of reasonableness under the Unfair Contracts Terms Act 1977. Any clauses seeking to restrict or exclude liability from fraudulent misrepresentation will be ineffective. The case of *Papa Johns (GB) Ltd v Doyley* [2011] makes it clear that the courts are reluctant to allow franchisors to benefit from such provisions due to the inequality of bargaining power and, as such, franchisors should ensure that they are careful and organised about the information provided to franchisees rather than solely relying on exclusion or limitation of liability clauses.

Failure to disclose – apportionment of liability

22 | In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Where a sub-franchisee has a claim for misrepresentation, it will be against that the appropriate sub-franchisor and not the franchisor. On the assumption that the franchisor or the sub-franchisor is a limited liability entity then individual officers, directors or employees will not generally be exposed to personal liability.

General legal principles and codes of conduct

23 | In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

The offer and subsequent sale of franchises will be subject to general principles of contract and tort law, and therefore the laws relating to misrepresentation will offer protection to franchisees.

The parties must be mindful of the concept of caveat emptor (buyer beware) and, therefore, carry out an appropriate level of due diligence. The concept of *culpa in contrahendo*, common in civil jurisdictions, places a duty to negotiate with care that could extend to making pre-contract disclosures and does not apply in the United Kingdom. Nor is there, as the law currently stands, a general implied duty of good faith.

Fraudulent sale

24 | What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

A franchisee can claim against the franchisor for fraudulent misrepresentation and, if successful, may rescind the agreement, or claim damages, or both.

Any clauses in the franchise agreement that seek to restrict or exclude liability from fraudulent misrepresentation will be ineffective.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There are no specific laws that regulate the ongoing relationship between the franchisor and the franchisee after the franchise contract comes into effect.

Operational compliance

26 What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

Franchise agreements will normally contain an obligation on franchisees to provide the franchisor with financial information including management accounts, annual accounts and value added tax returns (if applicable) enabling the franchisor to both monitor the franchisee's financial performance and to provide guidance and feedback on it. In practice, franchisees generally allow franchisors (through the terms of the franchise agreement) online access to this data. Franchisees may also be required to provide the franchisor with a business plan each year.

In addition, there will typically be an ability for the franchisor to carry out a complete audit of the franchisee's business to ensure compliance with operational standards. Where the franchisee's business is falling below those standards there will be a requirement to remedy those failings. In the event that the franchisee fails to do this then such a provision may allow the franchisor to treat the failure as a breach of the franchise agreement, remove a franchisee's territorial exclusivity or terminate the franchise agreement.

Amendment of operational terms

27 May the franchisor unilaterally change operational terms and standards during the franchise relationship?

Yes, the franchise agreement, if drafted correctly, will allow the franchisor to unilaterally change the operational terms and standards by amending the franchise manual, with which the franchisee will be required to comply. This assumes that the change does not conflict with the franchise agreement. While the franchise agreement will contain an obligation on the franchisee to comply with the manual in its entirety, where there are key policies and procedures that the franchisor envisages being updated periodically, it is advisable that the franchise agreement makes specific reference to the franchisee's need to comply with those policies and procedures.

Policy affecting franchise relations

28 Do other government or trade association policies affect the franchise relationship?

There are no mandatory government or trade association policies affecting the franchise association.

Voluntary members of the British Franchise Association (BFA) are required to comply with its Code of Ethics.

Termination by franchisor

29 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

The circumstances in which a franchisor may terminate the franchise relationship are detailed in the franchise agreement. Typically, there is a right to terminate the franchise agreement with immediate effect if the franchisee:

- ceases to operate the business;
- brings the brand into disrepute;
- commits a criminal offence;
- is the subject of an insolvent event or proceedings;
- repeatedly breaches the franchise agreement; or
- fails to remedy a breach within an agreed time frame.

The franchisor also has the right at common law to terminate the franchise agreement in the event of a repudiatory breach of it by the franchisee. A repudiatory breach is essentially a breach that goes to the core of the contract and deprives the innocent party of its benefit.

Termination by franchisee

30 In what circumstances may a franchisee terminate a franchise relationship?

Generally, a franchise agreement will not contain any express provisions allowing the franchisee to terminate it prior to the expiry of its term. However, the franchisee has the right at common law to terminate the franchise agreement in the event of a repudiatory breach of it by the franchisor.

Renewal

31 How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

The franchisee will be required on renewal to enter into the franchisor's standard franchise agreement. There are no laws setting out how franchise agreements are to be renewed or containing any requirements to be complied with on their renewal. Typically, there will be an obligation on the franchisee to notify the franchisor that it wishes to renew the franchise agreement during a time period specified in the franchise agreement.

Refusal to renew

32 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

There are no laws stipulating whether and on what terms the franchisor must renew the franchise agreement. Furthermore, there is no requirement under the BFA Code of Ethics that there must be a renewal of the franchise agreement.

The basis of renewal is a contractual one and the franchise agreement will set out conditions that must be met for the franchisor to agree to renew it. These will typically include a requirement that the franchisee is not in breach of the agreement, pays a renewal or administration fee and undertakes any required updates of its business operations or premises.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

A franchisor can and normally does restrict such transfers. The franchise agreement usually stipulates that the franchisor's consent to any transfer is required, which will be given subject to certain conditions being met. These conditions include the franchisor being satisfied that the prospective purchaser is a suitable candidate as a franchisee and the franchisee paying all sums owed to the franchisor, as well as certain costs associated with the transfer process. These provisions normally contain a right of pre-emption in favour of the franchisor, allowing it to buy the franchise business from the franchisee.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

There are no such laws or regulations.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

A franchisor may impose interest on overdue payments, which is typically specified in the franchise agreement. However, a franchisor must be wary that if the rate of interest is too high it may be considered a penalty clause and, therefore, be unenforceable.

Where no express provision is included in the franchise agreement, the default rate pursuant to the Late Payment of Commercial Debts (Interest) Act 1998 shall apply and currently stands at 8 per cent above the Bank of England base rate.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

Generally, there are no such laws or restrictions. However, in the event that a franchisor is operating in a country on which the United Kingdom has imposed financial sanctions, then restrictions may apply.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Yes.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

As the law currently stands, there is no general legal obligation on the parties to a franchise agreement to deal with each other in good faith.

Case law on this has been unsettled on this subject for some time. In *Yam Seng Pte Ltd v International Trade Corporation Ltd* (2013), the courts commented on the importance of recognising the concept of good faith in 'relational contracts', including franchise agreements. However, in *Carewatch Care Services Ltd v Focus Caring Services Ltd* (2014), the courts dismissed an argument from the franchisee that the franchise agreement contained an implied term that the franchisor and franchisee act in good faith towards each other. The courts took the view that, as the franchise agreement contained detailed terms dealing with all aspects of the franchise relationship, it was not necessary to imply any further terms.

Recent case law has suggested that the courts are becoming ever more willing to imply a duty of good faith into certain contracts, potentially including franchise agreements. In the case of *Sheikh Tahnoon Bin Saeed Bin Shakhboot Al Nehayan v Kent* (2018), it was held that the parties to a joint venture arrangement, entered into orally, owed each other a duty of good faith. Subsequently in *Bates v Post Office* (2019), it was held that a duty of good faith should apply as a matter of law to all 'relational' contracts and provided some guidance as to what a 'relational' contract might be. Under this guidance, franchise agreements may well be classed as relational contracts. However, in the case of *TAQA Bratani v Rockrose* (2020), the courts made it clear that the status of a contract as relational did not automatically imply that the parties owed each other a duty of good faith.

The BFA Code of Ethics requires parties to a franchise agreement to exercise fairness in their dealings with each other, and to resolve complaints, grievances and disputes with good faith.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

Franchisees are not currently treated in law as consumers.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

There is no such legal requirement. However, the BFA Code of Ethics requires that the franchise agreement is translated into the language of the franchisee's country and in which the franchisee is competent.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

Given the nature of franchise systems and the level of control that franchisors will wish to retain over the network, during the term of the franchise agreement franchisees will typically be subject to a number of restrictions. These include obligations to operate from specific premises or within specific territories, to purchase certain products or services from the franchisor or its nominated suppliers and not to be involved or interested in another business. Franchise agreements may also place restrictions on franchisees from selling goods or services above a particular price.

In addition, after the term of the franchise agreement, franchisors will seek to restrict franchisees from being involved or interested in a competing business from the premises or the territory in which the franchisee previously operated from or from competing with the rest of the network. These may also include restrictions on poaching certain employees or soliciting customers. While these restrictions will only be enforceable to the extent that they go no further than are reasonably necessary to protect the franchisor's legitimate business interests, recent case law makes it clear that well-drafted post-termination restrictive covenants that last for no longer than a year after termination or expiry of the franchise agreement are likely to be enforceable.

Courts and dispute resolution

42 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The United Kingdom is made up of more than one legal jurisdiction, with England and Wales along with Scotland being the largest two jurisdictions. Civil claims proceed differently in each jurisdiction, although the burden of proof is the same; namely, the balance of probabilities. In England and Wales, a franchisor would be expected to follow a pre-action protocol prior to commencing proceedings. A claim would be heard in either a local county court or the High Court. The High Court will ordinarily only hear claims with particular complexity, high value or cross-jurisdictional elements. Claims in Scotland proceed in the local sheriff court or in the Court of Session. Unlike in England and Wales, a claim can be commenced without the need to follow a pre-action protocol.

There is a strong emphasis on resolving disputes without resorting to litigation and different forms of alternative dispute resolution, such as mediation, are encouraged and may well become mandatory in the near future. Unreasonably refusing to engage in alternative dispute resolution can result in a party being punished in costs, regardless of whether they are the successful party at court. The BFA runs a mediation and arbitration scheme to resolve franchise disputes. It is common for franchise agreements to contain provisions requiring the parties to consider mediation before commencing proceedings, or that disputes are to be resolved by way of arbitration, rather than through the courts. Mediation should therefore be refused only after careful consideration and advice.

Given the length of time that claims take to progress through the court system, which can be years rather than months, some franchisors and franchisees are choosing to resolve their disputes through arbitration.

Governing law

43 Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

There are no restrictions on designating a foreign governing law in franchise agreements. However, the parties to the agreement will remain subject to certain mandatory laws that will apply notwithstanding the choice of jurisdiction, for example the Transfer of Undertakings (Protection of Employment) Regulations 2006, which seek to protect employees and workers in the event of business transfers.

Arbitration – advantages for franchisors

44 What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

The advantages of arbitration in the United Kingdom are similar to most jurisdictions, in that it generally offers a speedier and potentially less costly alternative to court proceedings, hearings are confidential to the parties and if the matter has particularly technical points an arbitrator with relevant expertise can be selected. The London Court of International Arbitration is recognised as a world-leading institution. The United Kingdom is a signatory to the New York Convention, allowing for enforcement of arbitral awards through convention protocols.

The parties to a franchise agreement may also decide to mediate. The Centre for Effective Dispute Resolution is a respected organisation offering mediation services. Members of the BFA also benefit from its mediation scheme.

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National treatment

45 In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

Foreign franchisors are treated in the same way as domestic franchisors.

UPDATE AND TRENDS

Legal and other current developments

46 Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

Following the United Kingdom's exit from the European Union on 31 January 2020, the transition period expired on 31 December 2020 when EU laws generally ceased to apply. However, the United Kingdom retained the EU's Vertical Block Exemption Regulation. As of 1 June 2022, this will cease to apply and will be replaced by the UK's Vertical Agreements Block Exemption Order (VABEO). The EU has also revised its block exemption.

While VABEO largely replicates the previous block exemption, there are some distinct differences, which may affect certain types of franchise networks. For example, it is no longer a hardcore restriction if a franchisor sells to franchisees goods which are intended to be sold online at a higher price than those which are intended to be sold offline, in order to reflect the investment costs involved in setting up a 'bricks and mortar' operation.

Furthermore, a certain type of parity obligation (or 'most favoured nation' clause), namely a wide retail parity obligation, whereby a supplier is required to offer to end users on one of its indirect sales channels (including on online platforms) its goods or services on terms no worse than it offers them on another sales channel, is now considered a hardcore restriction. Any agreement which contains such an obligation will fall outside of the safe harbour of VABEO. The change will no doubt have an impact on sectors such as the hotel industry.

United States

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MARKET OVERVIEW

Franchising in the market

1 | How widespread is franchising in your jurisdiction? In which sectors is franchising common? Are there any economic or regulatory issues in the market that are more or less hospitable to franchising or make it economically viable in your jurisdiction?

Franchising is woven into the fabric of the US economy. Franchised businesses operate in over 75 business sectors or industries. While restaurants and other food service operations account for approximately one-third of all franchise establishments, franchising is well represented in many sectors, such as automotive services, hotels, retail products and home healthcare services. Franchising is regulated at both the federal and state level, so companies seeking to franchise in the United States must be mindful of a broad array of legal considerations. Nonetheless, due to well-established financial and lending markets, real estate practices and legal systems, franchising has flourished in the United States.

Associations

2 | Are there any national or local franchise associations? What is their role in franchising, including any impact on laws or regulations? Are there any rules of conduct or membership requirements?

The pre-eminent franchise association in the United States is the International Franchise Association (IFA), which was founded in 1960. Generally, all franchisors, franchisees, and individuals and companies that supply goods or services to franchise systems can join the IFA. The IFA's mission is to protect, enhance and promote franchising. Membership of the IFA is voluntary. The IFA has adopted a code of ethics, which has no force of law.

There are, and have been, other organisations and associations related to franchising in the United States. Some of these have developed to address certain issues or subgroups (eg, the American Association of Franchisees and Dealers). There are also industry-specific franchise-related associations (eg, the National Auto Dealers Association and the Asian American Hotel Owners Association).

BUSINESS OVERVIEW

Types of vehicle

3 | What forms of business entities are relevant to the typical franchisor?

Franchisors are free to operate in whatever corporate form they choose. Limited liability companies and corporations are the most common forms of business entities used by franchisors. There are tax implications and other legal liability concerns that accompany a franchisor's choice of business entity.

Regulation of business formation

4 | What laws and agencies govern the formation of business entities?

Business entities are almost always formed pursuant to state law, typically by making an application to the relevant secretary of state. Foreign companies are free to choose the state in which they would like to form their business entity, although there are legal, tax and other implications that can impact this decision. It is common for foreign (and domestic) franchisors to choose Delaware as the state of formation. However, all states have enacted laws that govern the formation of business entities. When operating in multiple states, an entity formed in one state must register to do business in another state as a foreign entity, which is a simple ministerial process.

Requirements for forming a business

5 | Provide an overview of the requirements for forming and maintaining a business entity.

The requirements vary significantly depending on the type of business entity that a franchisor seeks to form. For instance, a general partnership can be formed by default if two or more individuals or entities operate a business together. Other types of entities, such as limited liability companies or corporations, must be filed with the relevant secretary of state or a similar state agency. The nature and substance of the documentation to be filed vary depending on the type of entity and the state's process. States typically require periodic document filing and fees to maintain the business entity.

Restrictions on foreign investors

6 | What restrictions apply to foreign business entities and foreign investment?

Foreign businesses are generally treated the same as domestic businesses under US laws. There are, however, a variety of laws that apply to foreign investment, many of which were enacted in the interest of national security. For instance, the Exon–Florio Amendment to the Defense Production Act of 1950 provides the federal government with the authority to review foreign investments in the United States for potential national security concerns. The USA PATRIOT Act and Executive Order 13,224, which are aimed at deterring terrorism, include restraints on transactions that involve suspected terrorists. Franchisors are prohibited from dealing with individuals included on the Specially Designated Nationals and Blocked Persons List maintained by the US Treasury Department's Office of Foreign Assets Control. Foreign investors are

also subject to certain reporting and disclosure requirements under the International Investment and Trade in Services Survey Act of 1976.

Taxation

7 What aspects of the tax system are relevant to franchisors? How are foreign businesses and individuals taxed?

Taxes are imposed in the United States by federal, state and local governments. A foreign franchisor is subject to the tax laws of the jurisdictions in which it operates. If the foreign franchisor establishes a US-based subsidiary as the US franchisor, that entity would be subject to US tax laws. Franchisors are subject to income taxes, which are generally assessed on revenues or income after certain deductions and adjustments. The federal tax rate ranges from 10 per cent to 37 per cent of taxable income. State and local taxes vary from zero per cent to 13.3 per cent of income. If the entity that is being taxed is a corporation, double taxation is possible, with income tax also imposed on the shareholders or owners. For certain entities (eg, limited liability companies and partnerships), the tax is passed through to the owners of the entities. The typical revenue received by a franchisor – such as initial franchise fees and royalty fees – are treated and taxed as ordinary income, and not at the lower capital gains rates.

Even if it does not have a physical place of business in the United States, a foreign franchisor is taxed on its US sources of income. If the foreign franchisor operates in the United States or creates a US subsidiary, the state in which the headquarters are located or in which the entity is formed may assess taxes on that entity. In addition, more states are seeking to assess taxes on out-of-state entities that are doing business in the state, even if they are not physically located there. Therefore, some states are seeking to assess income tax on foreign entities that merely have franchises operating in that state. Hence, an out-of-state franchisor may be subject to tax on the royalty income it receives from a franchisee located in a particular state. Out-of-state franchisors may be able to obtain credit on their home state taxes for taxes paid in other jurisdictions. States including California, Arizona, Kansas, New Mexico and Hawaii, among others, all take the view that foreign franchisors may be liable for state income tax if the entity has a substantial nexus with a state.

Federal law also requires that the tax on royalties paid to a foreign entity be withheld at the source and paid to the US Internal Revenue Service. However, certain tax payments may be reduced or exempted from withholding under some tax treaties.

Labour and employment

8 Are there any relevant labour and employment considerations for typical franchisors?

Generally, franchisors and franchisees are not considered to be in an employer–employee relationship. Rather, franchisees are classified as independent contractors and operate as separate legal entities. However, in recent years, some courts have found that franchisees may be deemed employees of their franchisor for purposes of labour, tax and other laws where the franchisor exercises excessive controls over the franchisees. The results in these cases turn on the specific facts at issue and the state-specific analytical frameworks, which vary. There have been several well-known cases that examine alleged employee misclassification and the franchise relationship in the janitorial services industry. Franchisors can mitigate the risk of having their franchisees classified as employees by structuring and implementing the franchise relationship in a manner that is consistent with state independent contractor laws. In addition, some franchisors only grant franchises to business entities, rather than individuals, in part to diminish the risk of misclassification.

In addition, franchisors operating in the United States face the risk that they may be deemed joint employers of their franchisees' employees. If a franchisor is deemed a joint employer, it can be liable for employment-related claims at a franchised business, such as wage and hour claims, harassment or discrimination. As a general rule, franchisors can be at risk of a joint employer determination if the franchisor controls, or has the right to control, the franchisee's employment-related decision-making. This could be either through operational realities, or through language in franchise agreements, franchise disclosure documents (FDD), manuals or other procedures and guidelines. Franchisors can mitigate the risk of joint employment by making certain changes to their franchise documents to emphasise the franchisee's status as an independent contractor and through certain operational practices, such as by providing only voluntary recommendations on employment issues.

Intellectual property

9 How are trademarks and other intellectual property and know-how protected?

One of the principal means for franchisors to protect their trademarks is through registration. Trademarks can be registered at state and federal level, although nationwide protection can be achieved only through federal registration. Unregistered rights in a trademark are governed by the common law and extend only to the geographic territory where the mark is used.

At the federal level, registration with the US Patent and Trademark Office (USPTO) gives the franchisor a nationwide priority of rights in the trademark. Once a trademark is registered with the USPTO, there is a rebuttable presumption that the registrant is the owner of the mark, that the mark is valid and that the registrant has the exclusive right to use it. The trademark owner may license others to use the mark and to pursue enforcement action against infringers. After five years, the registrant's rights in the mark become incontestable, which shields the registrant from certain challenges to the mark's validity.

The US Copyright Office also has a system for registering copyrights. A copyright attaches to an original work of authorship when it is created. While registration with the Copyright Office is not required, if the owner of a copyright wishes to bring a lawsuit for copyright infringement, the owner must register the work before bringing a claim.

Franchisors can take other practical steps aside from registration to protect their trademarks in the United States. For example, franchisors can ensure the continuing strength of their trademarks by using the marks consistently and avoiding changes in their appearance and presentation; using trademark notices (eg, the ® symbol for federally registered marks and the ™ symbol for all other marks) to demonstrate their ownership rights; and by taking action against infringers.

With regard to know-how, US law recognises the value in confidential methods and knowledge that become trade secrets. A trade secret is any information in any form that derives independent economic value from not being generally known or readily ascertainable and is the subject of reasonable efforts to maintain its secrecy. There is no documentation that must be filed with the government for information to be recognised as a trade secret. In 2016, the federal government enacted the Defend Trade Secrets Act for the protection of trade secrets. Forty-nine states have also adopted the Uniform Trade Secrets Act. For information to retain its status as a trade secret, a franchisor must monitor the information and take measures to maintain its secrecy. Anyone who has access to the information should be subject to strict written confidentiality obligations.

Real estate

10 What are the relevant aspects of the real estate market and real estate law? What is the practice of real estate ownership versus leasing?

All US states and many other jurisdictions have laws that address ownership, leasing, sub-leasing and transfers of real estate. These

laws are not specific to franchising. However, there are real estate issues that a franchisor may wish to consider. Namely, franchisors should take steps to exercise control over the premises of the franchised business so that, on termination or expiration of a franchise agreement, they do not lose valuable customer exposure, the location or signage.

Frequently, a franchisee leases the franchised premises from a third-party landlord. In that situation, a franchisor may want to require the franchisee to execute a conditional assignment of the lease, through which the franchisee and the lessor agree to assign the property to the franchisor upon termination or expiration of the lease, sub-lease or the franchise agreement. A franchisor may also require a franchisee's lease to contain certain prescribed terms, such as the right to receive notices of default under the lease, the right to cure a franchisee's default under the lease or the right to retrieve property that the franchisee abandons after the end of the lease term.

Competition law

11 | What aspects of competition law are relevant to the typical franchisor in your jurisdiction? How is competition law enforced in the franchising sector?

Several aspects of competition law in the United States are relevant to franchising. For instance, sourcing and price controls imposed by a franchisor are subject to certain limitations under federal and state antitrust laws, and under state franchise relationship laws.

It is permissible for a franchisor to require franchisees to buy products and services only from the franchisor, or its designated or approved suppliers. These restrictions must be disclosed in the franchisor's FDD. While a franchisee may challenge those restrictions as an unlawful tying arrangement under antitrust laws, such claims rarely succeed. With some exceptions, provided that the sourcing requirements were disclosed through the FDD or other pre-sale communications with the franchisee, these arrangements do not usually expose franchisors to antitrust liability. However, certain state franchise relationship laws (eg, the Washington Franchise Investment Protection Act) place limitations on sourcing requirements.

In addition, federal and state antitrust laws regulate pricing restrictions. Vertical agreements between franchisors and franchisees setting minimum or maximum resale prices are generally lawful under federal law. State law on this issue varies.

Most modern franchise agreements contain a non-compete covenant. The enforceability of a non-compete is principally governed by state law. Some states do not enforce a non-compete as a matter of public policy. However, many courts will enforce a non-compete if it is reasonable in terms of its durational and geographic restrictions, and necessary to protect the franchisor's legitimate business interests.

OFFER AND SALE OF FRANCHISES

Legal definition

12 | What is the legal definition of a franchise?

While federal and state jurisdictions share common definitional approaches, there is no universal definition of a franchise. Moreover, each jurisdiction has its own mix of definitional exclusions and exemptions.

Generally, a franchise is defined by the coexistence of three elements:

- a grant of rights to use another's trademark to offer, sell, or distribute goods or services;
- the grantor (or franchisor) providing significant assistance to, or exercising control over, the grantee's (franchisee's) business, which may take the form of a prescribed marketing plan; and
- the payment of a required fee.

If these three elements exist, the business arrangement is a franchise and the franchisor must comply with the applicable laws.

Laws and agencies

13 | What laws and government agencies regulate the offer and sale of franchises?

At the federal level, franchising is regulated by the Federal Trade Commission (FTC) primarily through the FTC's Franchise Rule (the FTC Rule). The FTC also has a Business Opportunity Rule that can apply to franchises.

At state level, 14 states have laws that regulate pre-offer and pre-sale disclosures and require franchise registration. These states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. Oregon has a franchise-specific law that does not require documentation to be filed with the government. In addition, 25 states have business laws that apply to business opportunities or seller-assisted marketing plans. Most of these contain exemptions for franchisors that meet certain criteria. However, of those states, six impose pre-offer and pre-sale documentation filing requirements on franchisors. These states are Connecticut, Florida, Kentucky, Nebraska, Texas and Utah. Also, 25 states and territories have laws that regulate the terms of the franchisor–franchisee relationship (after the grant or sale of a franchise). These states are: Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Idaho, Illinois, Indiana, Iowa, Louisiana, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, North Dakota, Rhode Island, Virginia, Washington and Wisconsin, as well as Puerto Rico and the US Virgin Islands. State relationship laws typically pertain to franchise terminations, renewals and transfers.

There are many exclusions and exemptions from both the FTC Rule and state laws, which are nuanced. There is no nationwide exemption from franchise laws.

Finally, the North American Association of Securities Administrators has guidance documents concerning franchise disclosures, which are deferred to by state regulators.

Principal requirements

14 | What are the principal requirements governing the offer and sale of franchises under the relevant laws?

The federal and state franchise laws and regulations are varied and include the following principal requirements:

- federal-level pre-sale franchise disclosure requirements;
- state-level pre-sale franchise registration and disclosure requirements; and
- state-level franchise relationship laws that govern the ongoing relationships between franchisors and franchisees, as well as between manufacturers and dealers or distributors, which impose requirements on terminations, renewals and transfers of franchises.

The federal and state laws regulating the offer and sale of business opportunities or seller-assisted marketing plans may also impose filing or disclosure requirements, or both.

Franchisor eligibility

15 | Must franchisors satisfy any eligibility requirements in order to offer franchises? Are there any related practical issues or guidelines that franchisors should consider before offering franchises?

Neither federal nor state laws impose experience or similar threshold requirements as a prerequisite to offering franchises. However, some

of the registration states may require inexperienced franchisors to defer their collection of initial franchise fees until the franchisor has completed its initial obligations and the franchisee has opened for business. Fee deferral may also be required based on a state's analysis of a franchisor's financial condition. Of course, a franchisor must comply with any applicable registration and disclosure requirements before offering franchises.

Franchisee and supplier selection

16 | Are there any legal restrictions or requirements relating to the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers? What practical considerations are relevant when selecting franchisees and suppliers?

No. The franchisor is generally free to contract with suppliers and franchisees of its choosing.

Pre-contractual disclosure – procedures and formalities

17 | What procedures and formalities for pre-contractual disclosure are required or advised in your jurisdiction? How often must the disclosures be updated?

At the federal level, the FTC Rule requires that franchisors who offer franchises anywhere in the United States must prepare a franchise disclosure document (FDD) and provide the FDD to prospective franchisees at least 14 days before signing a franchise agreement or accepting any consideration for the right to enter into a franchise relationship. The FDD must include 23 disclosure items and certain required appendices. Disclosures must be updated annually 120 days after the franchisor's fiscal year end and within a reasonable time after the close of each quarter to reflect material changes.

Fourteen states have pre-sale franchise disclosure and registration laws, though the disclosure period varies slightly by state. In these jurisdictions, a franchisor may not offer franchises in the state or to that state's residents unless the franchise offering is registered with the state. State laws require that FDDs must be updated at least annually or upon the occurrence of a material change, though what constitutes a material change and the exact timing of the required update varies by state.

Pre-contractual disclosure – content

18 | What information is the disclosure document required or advised to contain?

A US FDD must include 23 specific disclosure items, including:

- information regarding the franchisor and its business experience;
- fees payable by the franchisee;
- an estimate of the initial investment required to begin operations;
- information regarding support provided by the franchisor before and after the business opens; and
- a summary of the key terms of the franchise agreement.

The FDD must also include the franchisor's financial statements, copies of the forms of the franchise agreement and other contracts that a franchisee must sign, and contact information for all existing franchisees in the system.

A franchisor must obtain from the prospective franchisee a signed and dated FDD receipt page as evidence of proper disclosure.

Pre-sale disclosure to sub-franchisees

19 | In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Both the franchisor and sub-franchisor are jointly liable for compliance with disclosure laws. A sub-franchisor must provide an FDD to prospective franchisees. Certain aspects of the sub-franchisor's relationship with the franchisor must be disclosed in the sub-franchisor's FDD, such as the parties' trademark licensing arrangement. However, the parties' fee arrangement need not be disclosed. Additional disclosures pertaining to the franchisor must be disclosed in the sub-franchisor's FDD, including litigation and bankruptcy information about the franchisor.

Due diligence

20 | What due diligence should both the franchisor and the franchisee undertake before entering a franchise relationship?

Prospective franchisees should review the FDD, franchise agreement and related documents detailing the terms of the franchise relationship to understand the costs involved, the control exercised by the franchisor and the support services offered. Prospective franchisees should also speak to as many of the franchisor's current and former franchisees as possible. Prospective franchisees should also evaluate competing brands. Prospective franchisees should consider engaging financial and legal advisers, as well as industry-specific trade associations, to help assess the franchise opportunity.

Franchisors should establish criteria to assess each prospective franchisee, which should include:

- whether the franchisee is a good fit for the system;
- whether the franchisee has the appropriate experience (such as in business, management and human resources);
- whether the prospect meets minimum capital requirements;
- the availability of territory in the franchisee's ideal market; and
- whether it makes sense for the franchisor to expand into that region.

Failure to disclose – enforcement and remedies

21 | What actions may franchisees or any relevant government agencies take in response to a franchisor's failure to make required disclosures? What legal remedies are available? What penalties may apply?

The FTC may initiate an investigation or enforcement action against a franchisor for violation of the FTC Rule. This action can result in a court order that imposes penalties, such as recission of agreements or payment of fines, and enjoins the franchisor from continuing the violation. There is no private right of action available to franchisees under the FTC Rule. Only the FTC may pursue a violation of the FTC Rule.

States may also initiate an investigation or enforcement action against a franchisor for violation of a state registration or disclosure law (including business opportunity laws). States also routinely impose cease-and-desist orders, and require recission of agreements and payment of fines. Some state laws also provide for criminal liability for violations of state franchise laws.

FTC and state enforcement actions must usually be disclosed in a franchisor's FDD.

Failure to disclose – apportionment of liability

22 | In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

A franchisor is jointly liable with a sub-franchisor for disclosure violations. As in a unit franchising relationship, officers and directors of the franchisor or sub-franchisor may also be held liable.

General legal principles and codes of conduct

23 | In addition to any laws or government agencies that specifically regulate offering and selling franchises, what general principles of law affect the offer and sale of franchises? What industry codes of conduct may affect the offer and sale of franchises?

There are several general principles that apply to most contracts, such as common law concepts of fraud and misrepresentation.

Fraudulent sale

24 | What actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises?

In registration states, if a franchisor fails to provide proper disclosure or appropriately register, the franchisee may bring a claim under the applicable state law. Remedies available under state franchise laws may include rescission of the franchise agreement and damages. Similar relief is available for violations of business opportunity laws.

In addition, while there is no private right of action available to franchisees under the FTC Rule, states have passed unfair and deceptive trade practices acts, which are sometimes called Little FTC Acts. Many of these Little FTC Acts make violation of the FTC Rule a per se violation of the state's Little FTC Act. Aggrieved franchisees may also bring claims under these little FTC Acts. Common remedies also include recission and damages, including punitive damages.

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

25 | What laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

Twenty-five states and territories have enacted franchise relationship laws, and many of them govern the manner and procedure by which a franchisor may terminate, decline to renew or consent to a transfer of a franchise. For example, most franchise relationship laws require that a franchisor must have good cause to terminate a franchise and impose certain time periods during which a franchisee may cure defaults. Some of these laws are more limited, such as voiding venue selection clauses that force a franchisee to appear in court outside its home state or prohibiting the imposition of changes among similarly situated franchisees.

Operational compliance

26 | What mechanisms are commonly incorporated in agreements to ensure operational consistency and adherence to brand standards?

Franchisors generally reserve inspection and audit rights to monitor compliance with brand standards. Such inspections and audits may include formal or informal site visits by a representative of the franchisor, mystery shopper programmes or review of a franchisee's business records through remote access to a computer or point-of-sale system.

Amendment of operational terms

27 | May the franchisor unilaterally change operational terms and standards during the franchise relationship?

The franchisor is not permitted to unilaterally alter the terms of the franchise agreement. However, franchisors commonly reserve the right to alter the operations manual to modify the brand standards to reflect trends in the marketplace or new marketing techniques, technologies, and products and services.

Policy affecting franchise relations

28 | Do other government or trade association policies affect the franchise relationship?

The International Franchise Association has a code of ethics, but it has no force of law. Other associations that are formed may establish policies, but these policies would not have force of law.

Termination by franchisor

29 | In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

The terms of the franchise agreement establish the grounds on which a franchisor may terminate the franchise agreement. Common defaults include:

- insolvency or bankruptcy;
- abandonment of the franchised business;
- failure to pay amounts due;
- violations of health and safety laws; and
- failure to comply with system standards.

Franchise agreements commonly distinguish between curable and incurable defaults. If applicable, state relationship laws may override the terms of a franchise agreement.

Termination by franchisee

30 | In what circumstances may a franchisee terminate a franchise relationship?

Typically, franchise agreements expressly address when a franchisee may terminate a franchise agreement. In addition, common law may provide the franchisee with a right to terminate the franchise agreement upon a franchisor's material breach. Recission of the franchise agreement is permitted under some state laws if a franchisor failed to comply with disclosure requirements.

Renewal

31 | How are renewals of franchise agreements usually effected? Do formal or substantive requirements apply?

The terms of the franchise agreement generally establish the renewal requirements. Common renewal conditions include:

- prior notice of the franchisee's intent to renew;
- the payment of a renewal fee;
- execution of a general release of claims;
- good standing;

- a remodel of the premises; and
- the execution of the franchisor's then-current form of franchise agreement.

Disclosure is generally required on renewal if the franchisee would be required to sign a materially different form of franchise agreement than the agreement under which it had been operating.

Refusal to renew

32 | May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

If a franchisee has not complied with the conditions for renewal that are established in the franchise agreement, the franchisor may generally refuse to renew the franchise agreement. If applicable, state relationship laws may impose certain restrictions on a franchisor's refusal to renew.

Transfer restrictions

33 | May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes. Franchisors typically reserve the right to approve or disapprove a sale of the franchised business and any change in ownership of the franchisee entity. The terms of the franchise agreement dictate the processes applicable to a transfer. Common transfer conditions include:

- prior notice of the intent to transfer;
- the payment of a transfer fee;
- a remodel of the premises; and
- execution of a general release of claims.

The transferee must also meet the franchisor's standards for new franchisees, execute the franchisor's then-current form of franchise agreement and complete any required training. Franchisors also commonly reserve a right of first refusal to acquire the franchised business if a franchisee desires to transfer.

Certain state-specific franchise relationship laws may also affect transfers.

Fees

34 | Are there laws or regulations affecting the nature, amount or payment of fees?

No. Franchisors typically designate standard fees, which are disclosed in the franchise disclosure document (FDD), though franchisees are free to negotiate these fees.

Usury

35 | Are there restrictions on the amount of interest that can be charged on overdue payments?

Laws that limit the interest rate that may be charged (usury laws) have been enacted in all states.

Foreign exchange controls

36 | Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No. Generally, the United States does not impose currency or exchange controls on the transfer of money by a US-based entity (eg, a US franchisee) to a foreign entity, unless the foreign entity's home country is subject to sanctions. However, intellectual property-based payments to a foreign franchisor, such as royalty payments, may be subject to a 30 per cent withholding tax. If the United States and the foreign country are parties to an income tax treaty, the foreign franchisor may be entitled to a reduction or exemption.

Confidentiality covenant enforceability

37 | Are confidentiality covenants in franchise agreements enforceable?

Typically, yes. Reasonable confidentiality agreements are often enforced to protect the franchisor's intellectual property, trade secrets and other confidential information.

Good-faith obligation

38 | Is there a general legal obligation on parties to deal with each other in good faith during the term of the franchise agreement? If so, how does it affect franchise relationships?

Courts have held that an implied covenant of good faith and fair dealing generally applies to contracts, including franchise agreements. As applied by many courts, this covenant requires parties to deal with each other honestly and fairly, and a party cannot act to deny the other party the benefit of the bargain. However, the covenant of good faith and fair dealing cannot contradict the express terms of a contract. Therefore, franchise agreements are explicit in their description of each party's rights and responsibilities to reduce potential uncertainty, and to minimise potential claims alleging a breach of this covenant.

Franchisees as consumers

39 | Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

Treatment of franchisees as consumers varies by state. For instance, every state has an unfair and deceptive acts or practices statute, but the protections offered by those laws are state-specific.

Language of the agreement

40 | Must disclosure documents and franchise agreements be in the language of your country?

It is assumed that FDDs and agreements will be provided in English. FDDs and agreements filed in the registration states must be in English.

Restrictions on franchisees

41 | What types of restrictions are commonly placed on the franchisees in franchise contracts?

For the protection of the franchisor's brand, franchise agreements typically require the franchisee to closely follow the franchisor's business system. Accordingly, franchise agreements often require franchisees to sell all (and only) the goods or services that the franchisor designates, in accordance with the franchisor's standards and specifications. Usually, the franchisor may prescribe certain approved or designated suppliers, or a process by which a franchisor may vet alternate suppliers. Similarly, franchise agreements often contain tight restrictions on the franchisee's use of the franchisor's trademarks. The franchisor's business system is typically described in greater detail in an operations manual that is expressly referenced throughout the franchise agreement.

It is also typical in the United States for franchise agreements to designate an exclusive territory in which the franchisee must operate, though the size of the territory and level of exclusivity granted varies widely. Restrictions pertaining to confidentiality are also routinely included in

franchise agreements, as well as both in-term and post-term covenants against competition (though the enforceability of such covenants varies by state). Franchise agreements also contain lengthy provisions that pertain to dispute resolution, which may include requirements for mediation and arbitration, as well as the franchisor's choice of law and forum selection, which are also subject to state law.

Most franchise agreements contain restrictions relating to the transfer of the franchised business. Franchisors often require that the franchisee first obtain the franchisor's prior approval before transferring the franchise, though these requirements are also subject to state law.

Courts and dispute resolution

42 | Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The US federal court system, or the judicial branch, is one of three constitutionally prescribed branches of the US government. Due to federalism, US states have also established their own courts. The United States has a common law court system, which involves a formal adjudication process that creates law by establishing precedents.

Alternative dispute resolution methods are also commonly used to resolve franchise disputes. US law strongly favours the enforcement of arbitration agreements and many franchisors include broad arbitration clauses in their franchise agreements covering disputes arising from or relating to the franchise relationship (though some state laws purport to limit these arbitration agreements). Accordingly, a significant percentage of franchise disputes are arbitrated.

In addition, some franchisors and franchisees agree to pre-suit mediation as an alternative means of dispute resolution. Franchise agreements may even require that the parties first engage in mediation before initiating litigation or arbitration, and those provisions are generally enforceable.

Governing law

43 | Are there any restrictions on designating a foreign governing law in franchise contracts in your jurisdiction? How does the governing law affect the contract's enforceability?

The parties are generally free to choose the governing law of the franchise agreement. However, some state laws prohibit franchisors from designating a governing law that is different from the franchisee's home state.

Arbitration – advantages for franchisors

44 | What are the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction? Are any other alternative dispute resolution (ADR) procedures particularly favoured or disfavoured in your jurisdiction?

Arbitration has traditionally been viewed as offering several advantages over litigation, including:

- greater efficiency and lower costs due to more limited discovery and streamlined pre-hearing procedures;
- the ability to select an arbitrator with specialised experience;
- the ability to have the venue for the arbitration in the franchisor's home state (or country) and not in the franchisee's home state (if the Federal Arbitration Act applies);
- the opportunity to keep the proceedings confidential; and
- the general lack of a preclusive effect of an adverse arbitration award.

However, in practice, arbitration can be as costly and time-consuming as litigation. In addition, arbitration results in a binding decision and there are limited rights to appeal or challenge arbitration awards.

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National treatment

45 | In what respects, if at all, are foreign franchisors treated differently (legally, or as a practical matter) from domestic franchisors?

US franchise laws apply equally to US and foreign franchisors. One aspect of the US franchise disclosure laws that may affect foreign franchisors relates to financial statements. In its FDD, a franchisor must include its audited financial statements for the three most recent fiscal years (with certain adjustments for start-ups), prepared in accordance with US Generally Accepted Accounting Principles (US GAAP). Therefore, a foreign entity seeking to become a US franchisor must prepare its financial statements under US GAAP or include detailed conversions from international standards to US GAAP.

UPDATE AND TRENDS

Legal and other current developments

46 | Are there any proposals for new legislation or regulation, or to revise existing legislation and regulation? Are there other current developments or trends to note?

The Federal Trade Commission's (FTC) 10-year review of the entire FTC Franchise Rule, which was slated for 2018, is currently underway as of May 2022. The agency undertook the notice and comment regulatory process to obtain feedback from stakeholders, which closed in December 2020.

Anti-poaching provisions, which prohibit franchisees from hiring employees of other franchisees of the same brand (and sometimes apply to the franchisor's employees), were at one time commonplace in franchise agreements. However, beginning in early 2018, 15 state attorneys general announced that they were investigating anti-poaching language in franchise agreements. The State of Washington also began requiring franchisors to remove this language from their franchise agreements and agree not to enforce anti-poaching language in existing agreements. Since then, the FTC has expressed that it may promulgate trade regulation that would prohibit anti-poaching language. In addition, the Antitrust Division of the Department of Justice is also investigating franchisors' anti-poaching agreements.

Concerns pertaining to joint-employer liability and employee misclassification persist in the United States. The state of the law is very much in flux, in part due to the change in presidential administration in January 2021.

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