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Franchise Laws: What You Should Know Before Expanding Internationally

By Susan Grueneberg and Joshua Schneiderman

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Much has been written about the phenomenon known as "inadvertent franchising" in the U.S. — a situation that arises when a company, acting innocently enough, thinks it is granting a simple license but actually crosses the line into franchising. Inadvertent franchising can result in claims against the franchisor for rescission and damages, and can even result in individual liability for control persons.

While most articles on this topic focus on domestic inadvertent franchising, international franchise laws can be just as complex as U.S. franchise laws, and the implications of running afoul of international franchise laws can be just as severe. In fact, in many countries, there are few, if any, exemptions from these obligations. As a result, when a company considers international expansion, it is particularly important for the company's officers and advisors to be aware of which countries regulate franchising, what these laws require and what the implications are for violating them.

What are the elements of a contract that define a franchise? Under U.S. law, a franchise is defined as a commercial relationship with all of the following three elements:

- Trademark association – one party grants another the right to use its name or symbol.
- Payment of a fee – this is not limited to an initial fee, but can be payment for such things as training, lease or royalties (except for a reasonable inventory of goods sold at a bona fide wholesale price).
- Significant control or assistance with the operation of the business (some jurisdictions refer to a prescribed marketing plan or a community of interest between the parties).

Other countries that regulate franchises have varying definitions. While each country's definition of a franchise typically includes elements similar to those in U.S. laws, there are important variations across countries. For instance, France leaves the term "franchise" officially undefined, and Mexico does not require the payment of a fee. It is a very real possibility that a business model may not be a franchise in the U.S. but could be a franchise under the laws of a different country.

The manner in which franchising is regulated from country-to-country also varies considerably but typically requires some type of pre-sale disclosure, and in many cases, registration of the franchise offering. Some jurisdictions also require that the disclosure or the contracts or both be translated into the local language. Some countries require a franchisor to meet certain experience requirements in order to be eligible to franchise. In China, for example, a franchisor must have operated at least two units for one year in order to qualify.

The following countries have some type of franchise law:

- Australia
- Belgium
- Brazil
- Canada
- China
- France
- Indonesia
- Italy
- Japan
- Kazakhstan
- Lithuania
- Malaysia

- Mexico
- Romania
- Russia
- South Africa
- South Korea
- Spain
- Sweden
- Taiwan
- Venezuela
- Vietnam

Some of these laws also regulate the relationship between the franchisor and franchisee. This often takes the form of a restriction on the franchisor's ability to terminate the relationship. Some laws impose a duty of good faith on the parties.

Sometimes, the most routine preliminary steps in the parties' discussions about a possible distribution relationship can violate the requirements of the jurisdiction in which they plan to do business. One example concerns the Province of Ontario in Canada. Ontario's franchise law requires that disclosure be provided before any contract is signed or consideration is paid. Therefore, even the execution of a confidentiality agreement may result in a violation before the parties have even thought to consult with legal counsel.

Violation of these laws can result in consequences ranging from damages and a franchisee's right to rescind the agreement. Governmental authorities typically have the right to impose fines for violations of franchise laws.

Harsher penalties exist in other jurisdictions depending on the nature of the violation and the franchisor's willingness to comply with corrective actions imposed by regulatory authorities. For example, penalties for fraud in South Korea, such as providing false or misleading information or omitting to disclose material facts, can result in significant fines and even imprisonment.

Even if a jurisdiction does not explicitly regulate franchising, there may be other laws that a franchise relationship will trigger. In some countries, a trademark license may cause technology transfer laws to apply to the contract. Commercial agency laws, which are prevalent in the Middle East and Latin America, can present challenges to a franchisor seeking to protect its intellectual property while relying on a local distributor to develop its brand and market power. Currency repatriation can also be an issue requiring careful planning before the parties enter into a contractual relationship.

Working with local counsel familiar with franchising and experienced in cross-border transactions is indispensable in these situations in order to avoid the pitfalls that can plague an international relationship from the start.

Susan A. Grueneberg
213.929.2543
sgrueneberg@swlaw.com

Susan Grueneberg is a partner at Snell & Wilmer's Los Angeles office and a certified specialist in franchise and distribution law. She is a former Chair of the ABA Forum on Franchising.

Joshua Schneiderman
213.929.2545
jschneiderman@swlaw.com

Joshua Schneiderman is an associate of Snell & Wilmer's business and finance group, in the firm's Los Angeles office. He advises clients on a wide range of transactional matters, including mergers and acquisitions, franchising and public and private offerings of debt and equity securities.