

PANORAMIC **FRANCHISE**

USA



LEXOLOGY

Franchise

Contributing Editor

Mark Kirsch

Lathrop GPM

Generated on: July 25, 2024

The information contained in this report is indicative only. Law Business Research is not responsible for any actions (or lack thereof) taken as a result of relying on or in any way using information contained in this report and in no event shall be liable for any damages resulting from reliance on or use of this information. Copyright 2006 - 2024 Law Business Research

Contents

Franchise

MARKET OVERVIEW

Franchising in the market
Associations

BUSINESS OVERVIEW

Types of vehicle
Regulation of business formation
Requirements for forming a business
Restrictions on foreign investors
Taxation
Labour and employment
Intellectual property
Real estate
Competition law

OFFER AND SALE OF FRANCHISES

Legal definition
Laws and agencies
Principal requirements
Franchisor eligibility
Franchisee and supplier selection
Pre-contractual disclosure – procedures and formalities
Pre-contractual disclosure – content
Pre-sale disclosure to sub-franchisees
Due diligence
Failure to disclose – enforcement and remedies
Failure to disclose – apportionment of liability
General legal principles and codes of conduct
Fraudulent sale

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws
Operational compliance
Amendment of operational terms
Policy affecting franchise relations
Termination by franchisor
Termination by franchisee
Renewal
Refusal to renew
Transfer restrictions

Fees
Usury
Foreign exchange controls
Confidentiality covenant enforceability
Good-faith obligation
Franchisees as consumers
Language of the agreement
Restrictions on franchisees
Courts and dispute resolution
Governing law
Arbitration – advantages for franchisors
National treatment

UPDATE AND TRENDS

Legal and other current developments

Contributors

USA

Lathrop GPM



Eli Besignor

eli.besignor@lathropgpm.com

MARKET OVERVIEW

Franchising in the market

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.

Law stated - 16 May 2024

Associations

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).

Law stated - 16 May 2024

BUSINESS OVERVIEW

Types of vehicle

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.

Law stated - 16 May 2024

Regulation of business formation

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.

Law stated - 16 May 2024

Requirements for forming a business

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. Commencing in 2024, entities must comply with the Corporate Transparency Act, which requires non-exempt entities (domestic or foreign) that are created or registered to do business in the United States to report certain beneficial ownership information to the Financial Crimes Enforcement Network.

Law stated - 16 May 2024

Restrictions on foreign investors

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](#).

Law stated - 16 May 2024

Taxation

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.

Law stated - 16 May 2024

Labour and employment

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.

Law stated - 16 May 2024

Intellectual property

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 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.

Law stated - 16 May 2024

Real estate

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.

Law stated - 16 May 2024

Competition law

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.

In April 2024, the Federal Trade Commission (FTC) issued a rule that generally prohibits non-compete covenants between a 'worker' and an 'employer', which is set to go into effect in August 2024. However, the FTC specifically excluded from the rule non-compete provisions that apply to franchisees in the context of franchisor-franchisee relationships. The rule still prohibits non-executive employees of franchisors and franchisees of being subject to non-compete covenants. There are expected to be legal challenges to this rule.

Law stated - 16 May 2024

OFFER AND SALE OF FRANCHISES

Legal definition

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.

Law stated - 16 May 2024

Laws and agencies

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 (NAASA) has guidance documents concerning franchise disclosures, which are deferred to by state regulators. Some states elect to codify parts of NAASA's guidance into state law.

Law stated - 16 May 2024

Principal requirements

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.

Law stated - 16 May 2024

Franchisor eligibility

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.

Law stated - 16 May 2024

Franchisee and supplier selection

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.

Law stated - 16 May 2024

Pre-contractual disclosure – procedures and formalities

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, although 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, although what constitutes a material change and the exact timing of the required update varies by state.

Law stated - 16 May 2024

Pre-contractual disclosure – content

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.

Law stated - 16 May 2024

Pre-sale disclosure to sub-franchisees

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.

Law stated - 16 May 2024

Due diligence

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.

Law stated - 16 May 2024

Failure to disclose – enforcement and remedies

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 rescission 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 rescission 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.

Law stated - 16 May 2024

Failure to disclose – apportionment of liability

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.

Law stated - 16 May 2024

General legal principles and codes of conduct

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.

Law stated - 16 May 2024

Fraudulent sale

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 rescission and damages, including punitive damages.

Law stated - 16 May 2024

FRANCHISE CONTRACTS AND THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Franchise relationship laws

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.

Law stated - 16 May 2024

Operational compliance

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.

Law stated - 16 May 2024

Amendment of operational terms

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.

Law stated - 16 May 2024

Policy affecting franchise relations

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.

Law stated - 16 May 2024

Termination by franchisor

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.

Law stated - 16 May 2024

Termination by franchisee

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. Rescission of the franchise agreement is permitted under some state laws if a franchisor failed to comply with disclosure requirements.

Law stated - 16 May 2024

Renewal

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.

Law stated - 16 May 2024

Refusal to renew

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.

Law stated - 16 May 2024

Transfer restrictions

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.

Law stated - 16 May 2024

Fees

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), although franchisees are free to negotiate these fees.

Law stated - 16 May 2024

Usury

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.

Law stated - 16 May 2024

Foreign exchange controls

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.

Law stated - 16 May 2024

Confidentiality covenant enforceability

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.

Law stated - 16 May 2024

Good-faith obligation

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.

Law stated - 16 May 2024

Franchisees as consumers

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.

Law stated - 16 May 2024

Language of the agreement

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.

Law stated - 16 May 2024

Restrictions on franchisees

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, although 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, although these requirements are also subject to state law.

Law stated - 16 May 2024

Courts and dispute resolution

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.

Law stated - 16 May 2024

Governing law

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.

Law stated - 16 May 2024

Arbitration – advantages for franchisors

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.

Law stated - 16 May 2024

National treatment

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.

Law stated - 16 May 2024

UPDATE AND TRENDS

Legal and other current developments

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?

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 2023, the National Labor and Relations Board (NLRB) announced a new rule and analysis for determining whether an entity is a joint employer of another party. The new rule was broader in scope, and among other factors, provided that indirect or reserved control, even if never exercised, may result in an entity being classified as a joint employer. A federal court then held that the new rule was unconstitutional in March 2024, but it is expected that the NLRB will appeal that finding. As

of May 2024, joint-employer status continues to be analysed under the prior rule established in 2020.

In April 2024, the Federal Trade Commission (FTC) issued a rule that generally prohibits non-compete covenants between a 'worker' and an 'employer', which is set to go into effect in August 2024. However, the FTC specifically excluded from the rule non-compete provisions that apply to franchisees in the context of franchisor-franchisee relationships. The rule still prohibits non-executive employees of franchisors and franchisees of being subject to non-compete covenants. There are expected to be legal challenges to this rule.

Law stated - 16 May 2024