Newsletter of the INTERNATIONAL COMMERCIAL TRANSACTIONS, FRANCHISING AND DISTRIBUTION COMMITTEE

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Editor's Note

We are on a roll! Following the successful re-launch of our Newsletter in June, we're making good on our promise not only to keep the Newsletter going but to make each issue better than the one before. Our objective with the re-launch was to showcase the variety of topics encompassed within our Committee's mission. That allowed us to showcase Committee members from Argentina, Dominican Republic, Israel, Saudi Arabia and the US.

In this edition and the one to follow, we begin to focus on specific topics of interest to our Committee's members. Articles this quarter examine issues in international franchising and distribution transactions. In January 2014, we'll examine the impact of the CISG on international commercial transactions. Then, the Spring edition (April 2014) will kick off an annual "year that was," recapping important developments during the prior year that had an impact on international commercial, franchising and distribution transactions.

Many thanks to everyone who contributed to this edition, especially to our guest contributors - Alexandre Glatz and David Diris, President and Vice President of the Distribution Law Commission of AIJA, the International Association of Young Lawyers (www.aija.org). My contribution to their newsletter earlier this year and their contribution to this issue solidify what will hopefully be an active exchange and series of cooperative events between the AIJA Distribution Commission and our Committee.

As always, we welcome your suggestions, your ideas and, above all, your participation so that, together, we can make these newsletters a vibrant forum for addressing important topics and showcasing the expertise of our members.

Michael Daigle, Editor
August 20, 2013

Committee Leadership

(2013-2014)

Co-Chairs: Michael Daigle (michael.daigle@chengcohen.com)
Arnold Rosenberg (arosenberg@cwsl.edu)

Immediate Past Chairs: Caryl Ben Basat and William Johnson

Senior Advisor: Alan Gutterman

Vice Chairs: Eduardo Benavides, Francisca O. N. Brodrick, David William Clark, Adrian Lucio Furman, Dirk Loycke, Daniel R. McGlynn and Giuseppe Lorenzo Rosa

Steering Group: Brendan Berne, Caroline Berube, Joyce Chang, Chung Hwan Choi, Tom Collin, Mattia Colonelli de Gasperis, Carlos Eduardo Eliziário de Lima, Patrick Goudreau, and Kimberly Ann Palmisano

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COMMITTEE NEWS

Greetings:

The ABA's 2013-2014 bar year began in August and, while the new bar year brought transition for the Committee's leadership, we continue to have a great year with many opportunities for members to actively engage.

Thanks to out-going Committee Chairs, Caryl Ben Basat and Bill Johnson for their stewardship of the Committee for the past few bar years. Caryl and Bill are transitioning to other leadership roles with SIL and will be sorely missed here, but the impact of their efforts and their guidance of this Committee will be felt for years to come. Arnold Rosenberg assumes the co-chair position for the 2013-2014 bar year. While new to the role, Arnold is familiar to the Committee, having served for several years as a contributor to and editor of the Committee's submissions to the annual Year in Review edition of the Section's *The International Lawyer*.

Thanks also to everyone who has agreed to continue to serve or who has agreed for the first time to serve as a Vice Chair or Steering Group member. One of our key missions this bar year will be to expand the number of people who consistently contribute to and participate in the Committee's activities. We look forward to working with our Vice Chairs and Steering Group to make that happen.

Upcoming Activities:

- **2013 Fall Meeting** – We will sponsor or co-sponsor at least four of the programs at the London meeting (October 15-19). Please let us know if you plan to attend the meeting so we can explore opportunities for our Committee members to get together.
- **2014 Spring Meeting** – We have six programs under consideration for the meeting in New York, with topics that include insolvency, franchise negotiations, China transactions, anti-bribery and the CISG. We will keep you posted as we learn whether our submissions make it to agenda for the meeting. Thanks to everyone who prepared program ideas.
- **Committee Leadership Roles** – We continue to look for volunteers to serve in Committee leadership roles. Openings are available for Programs, Projects, Membership and Communications & Website. If interested in assisting in these or any other areas, please contact one of the Committee Co-Chairs.
- **Monthly Committee Calls** – We hold conference calls at noon eastern on the 3rd Wednesday of each month. The calls, which last no more than an hour, are important vehicles for keeping members abreast of the Section's and Committee's activities. All Committee members are invited to participate. Agenda items and dial-in information are circulated a day or so before each call. Anyone having items for a call agenda should reach out to the Committee Co-Chairs.
- **Year in Review** – Please watch for the call for submissions for the Committee's contribution to the Year in Review edition of the Section's *International Lawyer* publication. Our Committee has had strong contributions in the past, and we hope to continue as a significant contributor to this important publication.
- **Winter Newsletter** – The Winter edition of the Committee's quarterly Newsletter will be published in early January 2014 with a focus on the CISG. The CISG has been and continues to be an active discussion topic for our Committee, so we hope for a robust edition of the Newsletter. The deadline for submission of articles will be December 15. More information to follow.
- **Committee Webpage** – The link to our Committee's webpage on the ABA's website is: http://apps.americanbar.org/dch/committee.cfm?com=IC732000. The webpage holds a description of the Committee and its mission, a copy of the Committee's business plan, Committee roster, and copies of prior newsletters. Please check in on the webpage as we continue to improve and update the content.
- **Committee Business Plan** – We must submit the Committee's business plan for the current bar term by 30th September. We'll be posting drafts of the business plan on the Committee's webpage and will discuss it in more detail on the September Committee call. All Committee members, especially the Vice Chairs and Steering Group, are encouraged to participate in this process as it will shape what we do during the year and serve as a measure of our success as a Committee. due

Our combined mission is to make this Committee one of the SIL's most active, providing the highest quality materials, and delivering the most value to its members. We hope you'll help us get there and that you'll join us in these and other activities that will be made available through the Section and this Committee. Enjoy the articles that follow!

Michael Daigle, Co-Chair
Arnold Rosenberg, Co-Chair

BUSINESS FRANCHISES IN ARGENTINA (REVISITED) AND UNILATERAL TERMINATION OF ARGENTINA DISTRIBUTION AGREEMENTS

By Carlos E. Alfaro and Giselle Geuna

The business franchise has grown significantly in Argentina since the 1990s. According to the Argentine Business Franchise Association ("Asociación Argentina de Franquicias Comerciales"), there are about 600 franchisees in the country that integrate a network of over 5,000 franchised stores providing various products and services[1].

Despite the growth of this type of business in Argentina there is still no specific law that regulates it. The aim of this paper is to highlight that legislators have taken account of the importance of this contract and therefore included a special section regarding business franchise in the brand new Code Project that, if and when passed, would unify the Civil Code with the Commercial Code. The stated project improves the existing guidelines of earlier code's drafts by regulating the matter in a more comprehensive manner.

First, it must be stressed that the Code Project ends with the doctrinaire discussions regarding the correct business franchise definition. According to section 1512 of the Code a business franchise exists when a party, the franchisor, grants to another, the franchisee, the right to use a proven system designed to sell certain goods or services marketed under the trade name, emblem or the brand of the franchisor, who provides a set of technical knowledge and technical and continuous assistance in exchange of a direct or indirect benefit from the franchisee[2].

It also establishes that in order to be able to celebrate a franchise contract the franchisor must be the sole owner of all intellectual property rights, including trademarks, patents, trade names, and copyrights within the franchised system.

Section 1512 of the Code also adds that the franchisor cannot own shares that allow it to directly or indirectly control the business of the franchisee. By including this, the legislature attempts to protect the franchisee from the absolute control of the franchisor. The initiative is good and certainly provides an important limit to the customary influence of the franchisor on the franchisee. Nevertheless, although the law seeks for major transparency and franchisee independence, it must be noted that the franchisee will always find itself in an unavoidable position of control by special links (art. 33 Business Law -19.550-).

Finally, the mentioned section establishes that all business franchise contracts must have at least a minimum duration of two years. In Argentina, the average contract duration is 5 years[3]. There is no doubt that the law seeks to protect the investment of the franchisee setting a minimum that enables it to recover the investment. Nevertheless, section 1516 expressly states that a shorter period can be agreed by the parties for special events. This wisely contemplates the variety of business possibilities, but it applies to almost every business that can be structured through a franchise.

Furthermore, according to section 1514 of the Code the franchisor must: a) provide, previously to the signing of the contract, financial and economic information on the evolution of units similar to the one offered to the franchisee; b) communicate to the franchisee the set of technical knowledge derived from its own experience and tested by this as suitable for producing franchisee system effects; c) give the franchisee an operations manual with useful specifications of the activity specified in the contract; d) provide technical assistance for the optimum operation of the franchise during the term of the contract; e) ensure the provision of goods or services by the

[1] Mizraji, Guillermo J. H, *"La franquicia comercial en el Proyecto de Código"*, La Ley 4/01/2013.

[2] In a similar way the International Franchising Association defines the business franchise as a contractual relationship between a franchisor and a franchisee, in which the first offers to maintain a continuing interest in the business of the second, regarding to areas such as know-how and training, while the franchisee operates under a common trade name and according to a procedure or pattern established or controlled by the franchisor making a substantial financial investment from its own resources and its own business (Hubicki, Irene A., *"El contrato de franquicia comercial -Nueva aproximación a su estudio y problemática-",* El Derecho 198-619).

[3] Adrogué, Mercedes, *"El negocio del franchising en la Argentina y en el mundo. El contrato de franquicia"*, El Derecho 229-668.

franchisor or a third party appointed by it, in adequate quantities and at reasonable prices; f) defend and protect the use by the franchisee, under the conditions of the contract, of the rights referred on the mentioned section 1512 of the Code.

The obligations imposed on the franchisor reveal the clear purpose of the law to protect the franchisee. The obligation to provide information in advance of the signing of the contract allows the franchisee to fully analyze the business. The other duties imposed to on the franchisor coincide in general with the usual practices, but it must be noted the importance of the obligation to "defend and protect the use of the franchise by the franchisee" as a guiding principle in the matter.

On the other hand, section 1515 of the Code provides that the franchisee must: a) effectively develop the activity within the franchise and comply with the operations manual specifications; b) provide reasonable information requested by the franchisor regarding the development of the activity and facilitate inspections previously agreed; c) refrain from acts that could endanger the identification or the prestige of the franchise system that integrates and cooperate in the protection of the mentioned system; d) maintain the confidentiality of the information reserved to support the entire technical knowledge transmitted by the franchisor and ensure its confidentiality regarding dependents and third parties; e) comply with the obligations assumed in the contract.

The duties mentioned above also consistent with usual practices, but their expressed reference provides general guidelines that tend to ensure an appropriate relationship between franchisor and franchisee as well providing major legal security to the business.

The law continuously seeks to protect the franchisee as the weaker party in the contract. Toward that end, section 1516 of the Code nullifies any clause that prohibits the franchisee from justifiably questioning the franchisor's rights. Despite the real possibility of existence of such a clause in a franchising contract, note that the mentioned section of the Code provides a guiding principle that increases legal security to both parties by implying that the provisions can be challenged but only in a justified manner.

On the other hand, section 1517 of the Code ends with common issues derived from gaps regarding the exclusivity of the contract. The Project expressly states that franchising is exclusive for both parties. The franchisor cannot authorize another franchise unit in the same territory, except with the consent of the franchisee and the franchisee cannot operate by itself or through a third party franchise units or activities that are competitive.

The Project also establishes other rules with the aim to provide greater transparency to the business. For example, it states that the franchisor cannot sell directly to third parties, merchandise or services of the franchise within the territory or zone of influence of franchisee while the franchisee cannot assign its rights or contractual position emerging from the contract, etc.

Finally, it must be noted that section 1520 of the Code ends with many responsibility issues derived from the application of the labor legislation in the absence of specific regulation. It expressly establishes that the franchisor and the franchisee are independent parties and no employment relationship exists between them. Therefore, the franchisor is not liable for the obligations of the franchisee nor for the business success.

After a quick review of the regulation provided in the brand new Code Project, it can be stated that the Project clearly seeks to offer a framework of greater legal certainty while encouraging investment by protecting in a reasonable way both parties. It can always be improved, but for now, it is, in this author's view, more than sufficient to strengthen and encourage the expansion of this important business. As of the date of this article, the Code Project is still under revision at the committee level in the Argentine Congress.

Unilateral Termination of Distribution Agreements Without Cause

The distribution agreement is not specifically ruled under Argentine law. However, it has been defined by the local case law as an agreement through which the producer of goods or services (the "principal") agrees to supply them to another enterprise (the "distributor"), who acquires said goods or services to commercialize them by means of its own organization, acting for its own account and risk, receiving as profit for its activity a resale margin derived from the difference between the resale price and the price paid for its acquisition.

There are common characteristics of the distribution agreement, among others:

- *exclusivity in favor of the distributor*: the principal cannot commercialize the products, by its own or through third parties, which commercialization has been entrusted to the distributor, within the territory assigned to the distributor. It is considered a natural element of

the distribution agreement, but it may be excluded by agreement of the parties or renounced by distributor;

- *non-compete provision*: the distributor cannot sell (directly or by third parties) products that compete with the products of the principal that the distributor shall commercialize;
- *sales quotas*: minimum of sales of products that distributor obliges to carry out; and
- *provisions related to trademarks and advertising*.

In the case of fixed term distribution agreements, the unilateral early termination without cause is not admitted, except if it was expressly agreed by the parties. In the case of distribution agreements executed for an indeterminate term, it is admitted the possibility to unilaterally terminate the agreement without cause and at any time. However, such unilateral termination right cannot be exercised arbitrarily. Thus, the terminating party must give a "reasonable prior notice" of said termination in order to allow the other party to re-accommodate its activity and reestablish its economic balance.

Judicial precedents are unanimous with respect that the terminating party must give to the other party reasonable prior notice, but it is not uniform in determining how long in advance a prior notice should be served to become a "reasonable prior notice". Timing of the prior notice will depend on the particular characteristics of each case.

Custom practice and judicial precedents indicate that a prior notice should be given taking into account the following parameters, among others: (i) the length of the commercial relationship between the parties, (ii) the percentage of the distributor´s activity that the principal´s products represent; and (iii) investments made by distributor for the distribution.

In general, judicial precedents have considered reasonable a prior notice between six (6) and eighteen (18) months. Notwithstanding the above, it will depend on the particular characteristics of each case.

It is important to point out that the distributor has the right to an indemnification when the agreement terminates without prior reasonable notice or when such reasonable prior notice was given but there are other damages different to the absence of reasonable prior notice that the distributor has a right to claim. Also, the distributor would have the right to be indemnified in case there is in the agreement a clause allowing to terminate the agreement in any moment without cause but such clause or the exercise of such right was considered abusive.

In relation to the liability for damages arising from the termination of the agreement, part of the legal doctrine considers that a reasonable prior notice (so the distributor can re-accommodate its commercial activity) will prevent any claim for damages. This doctrine prevails over those who consider that some claims of damages may be admitted although prior reasonable notice was given. Most judicial precedents maintain the first criteria.

Generally, the items demanded by distributors in judicial proceedings derived from termination of distribution agreements are the following, among others: a) indemnification substitutive of prior notice (so called "*lucro cesante*"); b) goodwill (so called "*valor llave*"- which in general is not admitted by Court); c) clientele (which in general is not admitted by Court and it is considered included within the "*valor llave*"); d) investments made by the distributor that were not recovered; e) indemnification for labor (some judicial precedents denied this item, because they considered that this item is included within the indemnification substitutive of prior notice); f) moral damage (which in general is not admitted by Court). However, there are many judicial precedents that only admitted the indemnification substitutive of prior notice (so called "*lucro cesante*"), considering that all the other items (clientele, "valor llave", labor costs,-among others-) are included within the indemnification substitutive of prior notice.

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HOW TO TERMINATE A DISTRIBUTION RELATIONSHIP IN FRANCE OR IN BELGIUM

By Alexandre Glatz and David Diris

LEGAL FRAMEWORK

France

According to Article L 442-6 I° 5 of the Commercial code, a producer, trader, manufacturer or person listed in the trade register who (free translation) "*suddenly breaks off an established business relationship, even partially, without prior written notice taking into consideration the duration of the business relationship and in line with the minimal prior notice period determined in interbranch agreements by reference to the commercial usages*" is obliged to compensate for the loss caused.

Belgium

According to Article 2 of the Act of 27 July 1961 on the Unilateral Termination of Distributorship Agreements of Indefinite Duration (hereafter: Act 1961), certain distributorship agreements can only be terminated by the manufacturer when respecting a "*reasonable notice period*". Otherwise, the manufacturer can be condemned to pay an indemnity in lieu of notice, together with a supplementary indemnity.

APPROPIATE NOTICE PERIOD

France

The termination is sudden/brutal if the commercial relationship is ended without prior appropriate notice, except if justified by the breach of the terminated party of its contractual obligations or a force majeure situation. The reasonable notice period is a mandatory requirement which applies independently of the contractual provisions and overrules as such a shorter notice period or a contractual duration agreed by the parties.

Article L.442-6 I.5° does not contain any specific formula or rules for calculation of the notice period, even though it refers to the duration of the relationship. Hence, an appropriate notice period is determined on a case by case basis.

The chart hereunder provides an overview of the length of notice periods for relationships between 4 to 10 years, being noticed that for very long contractual durations (20 to 25 years) the notice period could reach up to 2 years:

Length of the established relationship	Appropriate notice period	Other criteria taken into account	Area	Decisions
4 years	1 year	-exclusive distribution -functioning by annual cycles	Exclusive distribution in the textiles activity	Orléans Court of appeals, march 8, 2012
4 years	1 year	-annual turnover -time to do the conversion	Distribution of shoes and accessories of the brand BENSIMON	Paris Court of appeals, September 12, 2012
7 years	6 months	-importance of the development performed by the victim -timing of substitution	distribution	Rennes Court of appeals, November 3, 2009
7 years	12 months	-TV programs meant to be broadcasted for one season	Production of magazines and features for a	Paris Court of appeals, July 1st, 2011, n°10/12993

Length of the established relationship	Appropriate notice period	Other criteria taken into account	Area	Decisions
		-the production company is dependant from the TV channel	TV channel	
9 years	9 months	-obligation to give time to the victim in order to reorganize its activities due to the loss of an important client	Distribution of advertising material	Paris Court of Appeals, October 28, 2005, n°03-19692
10 years	10 months	-exclusive nature of the distribution contract	Exclusive distributor of branded products	Lyon Court of appeals, January 8, 2009, n°07-8055
10 years	6 months	-nature and importance of the contractual links -possibility for the victim to address the situation	Distribution of chemical products	Paris Court of appeals, January 30, 2008, n°05-21167
10 years	3 months	-no exclusivity -no investments -limited business	Promotion of subscriptions to a magazine	Toulouse Court of appeals, may 13, 2009, n°07-5611

Belgium

The Act 1961 only foresees protection for certain categories of distributorship agreements: exclusive distributorships of indefinite duration (although the Act 1961 also created a very formalistic termination process for those of fixed duration). Exclusive distributorships include those where exclusivity was expressly accorded, as well as those where the distributor accomplishes a certain percentage of the total turnover of the manufacturer in the territory, as well as distributorships which impose certain obligations on the distributor.

Like in France, the Act requires that the distributor – other than in case of breach of contractual obligations or force majeure – is terminated with a reasonable notice period. Parties cannot determine the length of this notice period prior to the termination (except as ‘minimum’ notice period).

Similar as to France, the length of the notice period – if parties cannot agree upon after termination – will be determined by the Court case by case, taking into account several parameters (such as turnover of the distributorship in the total turnover of the distributor, level and evolution of this turnover, extent of the territory, …). Contrary to France, Belgian case law has altered in recent years where a long duration of the distributorship does no longer automatically equal a long(er) notice period.

The Belgian case law used to be known to be very in favour of the distributor, with record-breaking notice periods of 45 months. However, in recent years, the decisions of the Courts have become more balanced. Nowadays, it is still difficult to predict rulings under the Act 1961 as Court use and combine different parameters to base their decisions on. The table hereunder shows how surprising the outcome can be.

Length of the established relationship	Appropriate notice period	Other criteria taken into account	Area	Decisions
4 years	3,5 months	- 16% in total turnover	Sunglasses	Antwerp Court of appeals, June 15, 1988
4 years	10 months	-11,5% in total turnover - Benelux territory	Brand eyeglasses	Brussels Court of Commerce, September 30, 1999
7 years	6 months	-30% in total turnover - decreasing turnover	Beer	Brussels Court of appeals, January 30, 2004
7 years	18 months	-57,50% in total turnover - very specific market and products difficult to replace	Elements for model building	Nivelles Court of Commerce, February 18, 1997
9 years	6 months	- 10%in total turnover	Compressors for planes and cars	Brussels Court of Commerce, October 11, 1984
10 years	36 months	- Belgium and Luxembourg territory	Pharmaceutical products	Brussels Court of Appeals, May 4, 1971
11 years	3 months		Tubes	Verviers Court of Commerce, June 28, 1973
37 years	42 months	- Belgium and Luxembourg territory - all clients brought in by distributor	Cosmetics	Tournai Court of Commerce, June 23, 1994

CONSEQUENCES OF BEING IN BREACH OF THE LEGAL PROVISIONS

France

Except in case of a termination justified by the breach of the terminated party of its contractual obligations or a force majeure situation, the party which breaks off a business relationship (without giving sufficient notice) is liable to compensate the other party for the losses suffered as a result of such termination.

This corresponds usually to the gross margin which would have been realized by the party if sufficient notice had been given. Sometimes, the Courts retain the net margin or the "shortfall" without giving a precise definition of it. In any case, the loss never corresponds to the turnover that the victim could have expected during the notice period. Other losses (such as staff redundancy payments, lost opportunities for investment, loss of clientele, non-pecuniary harm…) may also be recovered if they can be proved to have been caused by the wrongful termination.

In addition, the French Minister of the Economy or the Public Prosecutor can bring an action in the civil courts against the party which terminated the relationship, or join the action of the "victim", for engaging in practices in breach of the provisions of Article L.442-6 of the Commercial code. They can then ask the Court to impose a civil fine of up to 2 million Euros and the compensation of the losses suffered can also be requested (Article L. 442-6 III of the Commercial code).

Belgium

Similar to France, terminating a distributorship agreement which falls within the scope of the Act 1961 without (sufficient) notice will result in the manufacturer being held liable for an indemnity in lieu. This

termination does not have to be expressly given, but can also be deducted from the behaviour of the manufacturer (f.e. violation against the exclusivity).

Although not written down in the Act 1961, the Belgian Courts will almost unanimously calculate this indemnity in lieu on basis of the monthly average (pre-tax) net profits increased by the unrecoverable fixed costs during a certain reference period (often the last 3 years before the year of termination). This monthly average is then multiplied with the months the manufacturer had to take into consideration as reasonable notice period. Art. 3 of the Act 1961 foresees also the possibility of a supplementary indemnity for certain categories of damages: clientele brought in by the distributor which remains with the manufacturer, expenses and investments done by the distributor during the relationship and indemnities payable to employees of the distributor for termination of their employment contracts as a result of the termination of the distributorship agreement.

The AIJA Distribution Law Commission is one of the most active scientific commissions within AIJA, a worldwide organization for and consisting out of lawyers under the age of 45. AIJA focuses on bringing together young lawyers in an international atmosphere, with high quality seminars and network events all over the globe. The Distribution Law commission concentrates on all aspects of distribution: from franchise over commercial agency until e-commerce and consumer protection. Their LinkedIn group is open for all distribution law professionals (www.linkedin.com/groups?gid=3106760).

Alexandre Glatz (GIDE NOUEL LOYRETTE, Paris, France) is President of the Distribution Commission and focuses on anti-trust, distribution and consumer law. He advises and assists clients before the French and European Courts when dealing with distribution networks, commercial litigation, consumer law issues and merger control. Email: glatz@gide.com

David Diris (KOCKS & PARTNERS, Brussels, Belgium) is Vice-President of the Distribution Commission and assists foreign clients with doing cross-border business in Belgium. His core activities include setting up distribution systems in Belgium (such as franchising, commercial agency, exclusive distributorships) as well as litigating distribution disputes. Email: david.diris@kockspartners-law.be.

FRANCHISING IN INDIA - A MAZE OF REGULATIONS

By Amrita Srivastava

Home to over one billion people, including a growing class of middle income families with significant disposable incomes, India can be a lucrative market for foreign franchisors. In fact, international fast food chains such as Subway and Pizza Hut, and fashion houses like Tommy Hilfiger and Calvin Klein, have successfully expanded their brands in India through franchising. In 2012, the franchising industry in India was worth US $13.4 billion and is expected to grow further by 30% over the next five years.[1]

Despite the popularity of the franchising model and its tremendous growth potential, India does not have a specific "franchise law". The franchising operations and transactions are governed by a patchwork of Indian laws that regulate business in general. Thus, U.S. businesses entering into a franchising relationship in India might find themselves going through a maze of regulations for every aspect of their business. The list below summarizes some of the unique legal issues that arise in international franchise transactions in India.

Agency v. Independent Contractor Relationship: The nature of the contractual relationship between the franchisor and the franchisee is determined by the Indian Contract Act of 1872[2]. If the franchisee is an independent contractor, then the franchisor will not be held liable for the franchisee's actions, but if it is determined that the franchisee is an agent of the franchisor, then the franchisor could be held liable for the franchisee's actions which are within the scope of the contract[3]. In general in India, the franchisee is considered an independent contractor. However, in some circumstances, the franchise agreement or the manner in which franchising transactions are conducted might end up creating an agency relationship.[4] Such a result might occur, if, for example, the franchisee is given the right to enter into third party contracts on behalf of the franchisor or ratifies some acts of the franchisee that are beyond the franchise agreement. In such situations, the franchisor might be held liable for the franchisee's torts or other violations of the law.[5]

Non-Compete Covenants**:** While non-compete covenants for the term of the contract are enforced in India, non-compete covenants that extend beyond the term of the contract are considered an unlawful restriction on trade.[6] In *Percept D' Mark (India) Pvt. Ltd. v. Zaheer Khan* the Supreme Court of India held that, "if the negative covenant is sought to be enforced beyond the term of the contract then it constitutes an unlawful restriction on the licensee's freedom to enter into fiduciary relationships with persons of his choice, and a compulsion on him to forcibly enter into a fresh contract with the appellant even though he has fully performed the previous contract."[7] The court also noted that the doctrine of "restraint of trade" is not confined to contracts of employment only, but is also applicable to all other contracts with respect to obligations after the contractual relationship is terminated.[8] Thus it is important for foreign franchisors to be aware of the potential threat of competition once the contract term is over.

Competition Act of 2002**:** India's Competition Act of 2002 prohibits any arrangements with respect to production, supply, distribution, storage, acquisition or control of goods or provision of services which cause or are likely to cause an appreciable adverse effect on competition within India.[9] Certain acts such as setting

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[1] KPMG & FAI, *Consumer Markets-Collaborating for Growth, A Report on Franchising Industry in India 2013, Pg. 7, (2013),* available at http://www.kpmg.com/IN/en/IssuesAndInsights/ArticlesPublications/Documents/Collaborating_for_Growth.pdf

[2] 1 Kenneth A. Cutshaw & Rohit Kochhar, *Corporate Counsel's Guide to Doing Business in India*, § 19:9 (3d ed. 2012)

[3] *Id.*

[4] *See* Indian Contract Act of 1872, Chapter 10, §185- Consideration not necessary for creation of agency relationship; §186- Agency relationship may be implied;

[5] *See* Indian Contract Act of 1872, Chapter 10, §238- Effect, on Agreement, of Misrepresentation or Fraud by Agent

[6] 1 Kenneth A. Cutshaw & Rohit Kochhar, *Corporate Counsel's Guide to Doing Business in India*, § 19:10 (3d ed. 2012)

[7] *Percept D'Mark (India) Pvt. Ltd. V. Zaheer Khan,* (2006) 4 S.C.C. 227

[8] *Id.*

[9] Competition Act of 2002, §3

prices and controlling supply, production, market, or technical development are presumed to be anti-competitive and render the relevant agreement void.[10] However reasonable restrictions such as those to protect the quality of goods and protect market from competitors during term of agreement have been allowed.[11] Competition Commission of India is the apex body that decides such cases.[12] Though similar to the U.S.'s Sherman Antitrust Act, a U.S. franchisor entering the Indian market should have counsel review its franchise agreement to determine its compliance with the Competition Act of 2002.

***Remitting Money and Taxes*:** Subject to the Foreign Exchange Management Act Rules (Current Account Transactions) 2000, royalty and other income from technology transfer agreements may be remitted after deducting applicable withholding tax. Under the Double Taxation Avoidance Agreement between India and U.S., the applicable withholding tax rate for royalties and fees for technical services is 10% in case of rental of equipment and services provided along with know-how and technical services, and 15% in all other cases (including trademarks).[13]

***Intellectual Property Laws*:** Since India is a signatory of the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS), most of its intellectual property laws are complaint with TRIPS and afford protection to a franchisor's intellectual property assets. Moreover, India is also a signatory to the Paris Convention and thus its intellectual property laws allow claim of priority from applications in member countries for registration of patents, trademarks, and industrial designs. India's Trademark Law of 1999 recognizes "well known marks" and provides marks that are identical or similar to "well known marks" cannot be registered.[14] It further provides for enhanced criminal punishment for offenses related to trademark to prevent the sale of counterfeit goods.[15]

***Consumer Protection Laws*:** The franchisor could be held directly liable for violations of India's consumer protection laws. Under India's Consumer Protection Act, 1986, a number of persons could be held liable for a defective product or service, including *"any person who puts or causes to be put his own mark on any goods made or manufactured by any other manufacturer."*[16] Thus, to minimize risk, it is important for the franchisor to clearly demarcate in the franchise agreement the liabilities for defective products and deficient services between itself and the franchisee.

***Government Approvals*:** In India, an international franchising transaction is considered a foreign technology collaboration between the franchisor and the franchisee. Until recently, government approval was required for all foreign technology collaborations that involved a lump-sum payment of more than U.S. $2 million, or royalty payment of more than 5% on domestic sales and 8% on exports for technology transfer, or 1% on domestic sales and 2% on exports for license of trademarks.[17] In 2009, the Government of India withdrew these restrictions and allowed remittance of these payments without government approval, subject to the Foreign Exchange Management Act Rules (Current Account Transactions) 2000.[18]

***Pre-Sale Disclosure of Information*:** Unlike the U.S., where franchisors are required to disclose a large amount of information to potential franchisees and provide that information in a specific format, India does not have regulations requiring such disclosure. In practice, most franchisors do disclose information about their structure, management, litigation history, and the franchise opportunity to the Indian franchisee to ensure transparency and minimize unforeseeable risks.[19]

***State Authorities and Regulations*:** Apart from the federal laws and agencies, the franchise operations will

[10] *Id.*

[11] *Gujarat Bottling Co. Ltd. V. Coca-Cola Co.*, 1995 AIR 2372, 1995 S.C. (5) 545 (allowing a franchise agreement that restricted the bottling company from providing services to a competitor), and Registrar of Restrictive Trade Practices v. United Breweries Ltd. & Anr. (1986) (MRTP) (allowing restrictions on supplier for maintaining quality of goods)

[12] Competition Act of 2002, § 7

[13] Income Tax Department of India, Withholding Tax Rates, Tax Rates Applicable in India under ADT Agreement, available at http://law.incometaxindia.gov.in/DIT/File_opener.aspx?fn=http://law.incometaxindia.gov.in/Directtaxlaws/dtrr2005/R10.htm

[14] Trade Marks Act of 1999, § 11 (2)

[15] Trade Marks Act of 1999, § 103

[16] Consumer Protection Act of 1986, § 2(j)

[17] Government of India, Ministry of Commerce and Industry, Department of Industrial Policy & Promotion, Press Note No. 8 (2009 Series), available at http://dipp.nic.in/English/acts_rules/Press_Notes/pn8_2009.pdf

[18] *Id.*

[19] 1 Kenneth A. Cutshaw & Rohit Kochhar, *Corporate Counsel's Guide to Doing Business in India*, § 19:28 (3d ed. 2012)

also be affected by various state laws and agencies such as real estate laws, shops & establishment acts, state specific labor laws, and taxation rules. It is important for franchisors to understand the regulatory environment in different states before picking an appropriate franchisee.

Industry Specific Laws**:** Apart from the laws discussed above, a number of other regulations might apply to a franchisor's business depending on the franchisor's specific industry. For example, franchisors in the food and beverage industry will need licenses/permits from the State Food (Health) Authority.

Conclusion

Given the rate at which the franchise business model is expected to grow in India, it is this author's view that India should be considering a framework of regulations around the industry. Such regulation would provide the legal stability that foreign franchisors are familiar with and thus encourage further growth of the industry.

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DOING BUSINESS IN SAUDI ARABIA: ESTABLISHING COMMERCIAL AGENCY AND DISTRIBUTION AGREEMENTS

By Wassem M. Amin

Saudi Arabia is one of the largest importers of goods in the Middle East region and is, in fact, one of the largest per capita importers of goods in the world. Saudi Arabia imports virtually all consumer and industrial goods that it uses. It imports roughly triple the amount of goods that it exports. For example, according to the Kingdom's Central Department of Statistics and Information, in 2012, total imports were approximately 584 Billion Saudi Riyals (US $156 Billion) compared to non-petroleum related exports of 190 Billion Saudi Riyals (US $50 Billion).

With the recently-announced record 2013 national budget, demand for imported goods is expected to exponentially rise. Most foreign companies seeking to establish a long-term presence in Saudi Arabia choose to do so via a commercial agency agreement with a local partner. Commercial agency agreements in the Kingdom are governed by the Commercial Agency Act and associated regulations (the "Act"). The law does not differentiate between a distributor or an agent and, therefore, the Act is applicable to both types of contractual relationships. These two terms are used interchangeably in this Article.

The Act defines a commercial agency relationship as a contractual relationship between a Saudi company or individual and a foreign producer or their representative for the purpose of undertaking trading and commercial activities in the Kingdom.

Who Can Act as Agent/Distributor in Saudi Arabia?

The Act requires that the local agent or distributor be either a Saudi national (or 100% Saudi-owned company) or a citizen of the Gulf Cooperation Council (GCC). The GCC's members include the countries of: Bahrain, Kuwait, Qatar, Oman, Saudi Arabia, and the United Arab Emirates. In addition, the entity or individual must register with the Ministry of Commerce and the chamber of commerce in the region where the majority of trading activities will be undertaken.

Legal Obligations of Agents & Distributors

The Act imposes stringent legal obligations that function as a "warranty" for any goods distributed by the local agent. Among the most significant are the requirements that an agent provide spare parts at 'reasonable prices' as well provide maintenance and repair services. This requirement is imposed for a period of one year even after the termination of the agency agreement with the producer or until the appointment of a new agent. The agent is also required to maintain extensive documentation disclosing all customs/duties information and the country of origin of the product.

The Commercial Agency Agreement

In order to impose uniform rights and obligations on all local agents and their foreign principals, the Ministry of Commerce has a standardized model contract which serves as a guide for both parties. Although the agent and principal are not required to use the model contract, the use of a contract with terms that substantially differ from the model will prevent that agency relationship from being registered with the Ministry of Commerce--essentially invalidating the contract.

The mandatory terms in a commercial agency agreement, as set out by the Ministry of Commerce, are the following:

- Parties to the Agreement;
- Territory covered by agency;
- Duration of agency;
- Conditions for termination and renewal;
- Rights and responsibilities of each party towards each other and the consumer--specifically who is responsible for the cost of maintenance and provision of spare parts;
- The products and services that are covered by the Agreement;
- Capacity of the local agent, i.e., whether the agent is a direct representative of the principal or is an independent distributor; and
- The terms of payment or formula for remuneration.

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THE SAUDI ARABIAN JOINT VENTURE: BEST PRACTICES

By Amgad Husein and Fadil Bayyari

INTRODUCTION

The Kingdom of Saudi Arabia is at the center stage of growth and investment in the Middle East and, in particular, the Arabian Gulf region. The country is the largest oil producer and exporter in the world, maintains a high GDP, and has a labor force of over 8.5 million. In the past decade, Saudi Arabia has embarked on a plan to become the regional economic center in the Middle East, and to diversify away from an almost exclusively petroleum based output to other viable economic sectors, including but not limited to, defense, education, energy, healthcare, industry, and infrastructure. A key factor in this initiative has been the influx of foreign investment from other major economic players, the most notable of which has been from the United States.

As foreign investors in Saudi Arabia would likely point out, Saudi Arabia's legal system has moved at a somewhat unequal and irregular pace in comparison to its economy. While the Saudi Arabian economy has experienced insurmountable growth rates, the legal system, on the other hand, remains at an early stage of development. For instance, many areas of Saudi Arabian law remain practically untested or underdeveloped. In addition, there exists a body of government policy influencing changes to existing law that oftentimes goes unpublished. On top of it all, Saudi Arabia does not follow the principle of *stare decisis*, thereby leaving no collection of precedent to follow. In summary, investors are faced with a legal system and process that is evolving.

In light of the foregoing, foreign investors in Saudi Arabia seek the opportunity to engage in simple solutions offering desirable results. One such solution is the Saudi Arabian joint venture (JV). A JV allows foreign investors to invest capital in Saudi Arabia while leaving many of the complex commercial and legal hurdles to the Saudi JV party. The right Saudi partner can provide the foreign investor with invaluable business contacts as well as know-how gained from years of experience by living in Saudi Arabia and operating within its market.

Over the years, we have developed several strategies and best practices which we use to advise our non-Saudi clients seeking to establish a JV. This article will briefly discuss the basic legal requirements for establishing a JV entity and end with a detailed analysis of our best practices with regard to the formation of the JV and advice going forward.

BEST PRACTICES

The Basic Legal Requirements of a Saudi Arabian Joint Venture

As a preliminary matter, the parties to a JV must first agree to contractual terms in a joint venture agreement. Once agreed, the foreign entity must form a legal presence in Saudi Arabia, as discussed in further detail below, and obtain a commercial foreign investment license from the Saudi Arabian General Investment Authority (SAGIA) and a commercial registration certificate from the Ministry of Commerce and Industry (MOCI). After obtaining these preliminary documents, foreign entities are free to proceed further to the objectives of the JV.

In most cases, foreign companies can operate in any sector in Saudi Arabia. However, certain sectors are on the negative list, which means that foreign companies are not permitted to operate in Saudi Arabia in these sectors. These sectors include, oil exploration, drilling and production; manufacturing of military equipment and devices; security services; recruitment and employment services; real estate brokerage; audio-visual and media services; land transportation services; and fisheries.

Best Practices

1. Establish a Saudi Arabian Limited Liability Company

When a foreign entity wishes to enter into a JV with a local Saudi partner, whether or not a Saudi partner is required, the parties will need to form a company. The LLC is the most commonly preferred option in Saudi Arabia because it is generally the most straightforward entity that allows foreign investors to establish a permanent presence in the Kingdom. Further, LLCs can be wholly foreign-owned, depending on the industry in which they operate. For this reason, we focus on the formation of LLCs in Saudi Arabia as discussed in further detail below as our first best practice recommendation.

The minimum paid-up capital required to form an LLC is generally SAR 500,000 (approximately US$133,333 based on the exchange rate of SAR 3.75 for each US$1). Further,

an LLC requires between two and fifty shareholders, each shareholder's liability limited to his capital contribution.

There are five basic steps to forming a Saudi LLC. First, a foreign investor must obtain an investment license from SAGIA in order to form an LLC. When approaching SAGIA for a foreign investment license, the foreign entity must provide specific information concerning its general financial condition and disclose the proposed financial structure of the LLC. Second, and after receiving the license, the foreign entity must take the license and the LLC's Articles of Association to the MOCI for review and approval. Third, and after the MOCI's approval, the shareholders must execute the Articles of Association before a Saudi notary public and a synopsis of the Articles must be published in the Official Gazette. Fourth, the shareholder will then take the executed Articles and a letter from an in-Kingdom bank certifying that the required amount of capital has been deposited therein to the MOCI. Finally, and once all required documentation has been received, the MOCI issues the certificate and the LLC is born.

The above steps to forming a Saudi Arabian LLC will generally require the following documentation from the parties of the JV:

- SAGIA application;
- A timetable for implementation of the project after the SAGIA license is issued;
- Resolutions from each shareholder agreeing to establish the LLC;
- Certificate of incorporation, certificate of good standing and articles of association (or similar document) for each shareholder;
- Power of attorney to the individual who will be the general manager of the LLC and the necessary resolutions appointing the general manager;
- Power of attorney from each shareholder to members of a Saudi law firm to carry out the licensing procedures for the LLC;
- Statement of the capital to be contributed initially for operation of the LLC, specifying the cost of equipment, facilities, and salaries;
- Memorandum of understanding between each shareholder agreeing to the formation of the LLC;
- Audited financial statements of each shareholder for the last three (3) years;
- Certificate from an in-Kingdom bank evidencing that the paid-up capital has been deposited; and
- Copy of the LLC's initial office lease.

The documents provided by the foreign entity will need to be notarized locally in the entity's country of origin and legalized up to the relevant Saudi Arabian embassy or consulate.

2. Carefully craft the description of the company's purpose

One of the more important, and often overlooked, strategies is ensuring that the description of the company's purpose in the company's articles of association is certain, definite, unambiguous and does not fall within one of the statutorily prescribed items falling within the negatives list (as discussed above).

SAGIA is known to heavily scrutinize the purpose statement for failing to providing certain and definite business objectives or for riding too close to the negatives list (as briefly discussed above). Those who fail to choose their JV purpose carefully could find themselves facing a regulatory challenge by SAGIA or, even worse, a complete and unappealable rejection of the SAGIA application. In addition and equally important, once the company's purpose is chosen, it can no longer be changed without seeking additional approval from SAGIA. As such, the company's activities will be restricted to carrying out the purpose as stipulated in the articles of association.

3. A choice of law and forum clause that does not employ Saudi Arabian law and jurisdiction is not always advisable.

Many JV parties seek to insert choice of law and forum selection clauses, whether for arbitration or litigation, that allow for options other than Saudi Arabian law and jurisdiction. While this is generally possible in Saudi Arabia, it is not always advisable. For instance, we are currently not aware of any foreign arbitral awards that have been enforced in Saudi Arabia. Generally, these awards are re-litigated by the Saudi Arabian Board of Grievances-- Saudi Arabia’s court of general jurisdiction for commercial matters--under Saudi Arabian law and regulations, irrespective of the choice of law clause selected by the parties.

For this reason, we often recommend our clients to consider choosing Saudi Arabian law as its choice of law and the Board of Grievances as its forum.

4. The majority shareholder should structure the articles of association to retain as much power over the operations and management of the company as possible.

The majority shareholder, if any, of the JV bears the most economic risk. As such, the majority shareholder should retain as much control over the operations as possible in order to safeguard his investment. In particular, we recommend that the articles of association provide the majority shareholder with the power to appoint the general manager (GM) of the LLC, including the right to determine what powers and authorities the GM shall have. This allows the majority shareholder some discretion as to how the company shall be managed, the types of contracts the GM can enter into, the employees the GM can hire, and so on.

5. A high paid up capital is not always advisable

Under Saudi Arabian law, at least 10% of the net profits of an LLC must be set aside each year to build up a statutory reserve fund. The shareholders may resolve to discontinue setting aside the net profits for the statutory reserve only when the reserve amount equals at least 50% of the LLC's paid up capital (hereinafter the Statutory Threshold).

In this regard, the higher the paid up capital of the LLC, the more challenging it is to satisfy the Statutory Threshold and forego the setting aside of net profits.

6. Ensure the joint venture agreement obligates the parties to pertinent anti-corruption regulations

Last, and certainly not least, most foreign investors, and in particular US and UK investors, must comply with anti-corruption legislation such as U.S. Foreign Corrupt Practices Act and the UK Bribery Act (collectively the Acts), respectively, when doing business abroad. In this regard, we recommend that the JV agreement contain a clause requiring the parties to agree to comply with the foreign party's relevant anti-corruption legislation. This is important because a U.S. or UK entity can be held liable for the actions of its Saudi partner under these Acts.

For U.S. investors, further attention should be paid to compliance with the rules on detection and prosecution of money laundering and financing of terrorism enacted under the Patriot Act in order to enable the U.S. government to obtain, verify, and record information that identifies the Saudi Arabian parties in accordance with the Act. In addition, U.S. investors will need to ensure that each party to the JV agreement shall comply with relevant export control laws and regulations; import control laws and regulations; United States anti-boycott regulations, customs laws and regulations, and the United States economic sanctions regulations.

Finally, it is not uncommon for Saudi parties to suggest that the JV agreement comply with Saudi Combating Bribery Law (CBL). While similar to U.S. and UK anti-corruption legislation, the CBL does not cover all issues sufficient to arise to the level of scrutiny under the Acts. In this regard, we do not recommend that a foreign JV party obligated to comply with either or both Acts choose the CBL over the Acts.

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RECENT DEVELOPMENTS IN SOUTH KOREAN FRANCHISE LAWS

By Philippe Shin, Byung-Tae Kim & Hyunju Lee

Major Provisions of Fair Transactions in Franchise Business Act

On July 2, 2013, the National Assembly passed a partial amendment (the "Amendment") to the "Act on Fair Transactions in Franchise Business"(the "Franchise Act"). The Amendment will become effective six months after its proclamation (expected in February 2014).The major purposes of the Amendment are: (i) to strengthen the rights of franchisees; (ii) to remedy unfair practices of franchisors; and (iii) to strengthen the obligation to provide information. The key aspects of the Amendment are detailed below.

Extended Prohibition of Unfair Transactions by Franchisor

- *Prohibition of imposition of store environment improvement on franchisees and obligation of cost sharing (Article 12-2)*: The Amendment added a new provision prohibiting a franchisor from imposing store environment improvement on its franchisees without justifiable reasons. Under the new provision, a franchisee will bear the cost of store environment improvement at a rate determined by Presidential Decree, to the extent such rate is less than 40%; *provided, however,* that if a franchisee has to improve its store environment due to sanitation or safety concerns resulting from works voluntarily performed by the franchisee or otherwise attributable to the franchisee, without the franchisor's request, the franchisor is not required to bear the cost.

- *Prohibition of restriction of business hours (Article 12-3)*: The Amendment prohibits the practice by certain franchisors of unfairly restricting the franchisee's business hours. Thus, it shall be deemed as unfair restriction of business hours if the franchisor does not permit a franchisee to reduce its business hours, (i) even though such franchisee has suffered losses due to its operation during night hours, as the relevant sales are lower than the cost, or (ii) even though such franchisee requests a reduction in business hours due to unavoidable circumstances, such as disease or treatment of disease.

- *Protection of business area (Article 12-4)*: Before the Amendment, there was no provision requiring the franchisor to define a business area. The amended Franchise Act now provides that, when executing an agreement, the franchisor is obligated to define and stipulate the business area for a franchisee in the agreement. Further, the franchisor is not permitted to set up another franchisee or any shop of the same trade or otherwise directly operated by the franchisor in the same business area without justifiable reasons; *provided, however,* that in the event of any cause stipulated by Presidential Decree, the business area may be reasonably adjusted through consultation between the franchisor and the franchisee at the time the relevant franchise agreement is renewed. This new provision is scheduled to become effective one (1) year after the proclamation of the Amendment as its implementation must in practice be preceded by a grace period to adapt to the new requirements.

Increase in Franchisor's Obligation to Provide Information

The Amendment contains new provisions that require franchisors to provide written materials on estimated sales. Under the pre-amendment Franchise Act, franchisors are required to allow franchisees or potential franchisees to access information related to sales forecast only at their request. Under the Amendment, however, all franchisors over a certain size (determined by Presidential Decree) shall provide potential franchisees with the scope of estimated sales and the relevant calculation grounds at the time of execution of a franchise agreement, and shall maintain such information for five (5) years from the date of execution of the franchise agreement (Article 9(5)).

In addition, the Amendment requires franchisors to provide disclosure documents by content-certified mail or other means prescribed by Presidential Decree, from which the date of provision of information can be identified. The Amendment strengthens the overall disclosure obligations by (i) requiring franchisors to specify whether they have violated the "Act on General Terms and Conditions" and information on franchisor's assistance for the management and sale activities of franchisees in disclosure documents, and (ii) increasing the amount of the fine in case of provision of false or exaggerated information (Article 7).

Measure to Strengthen Protection of Franchisee's Rights and Negotiation Leverage

The Amendment permits franchisees to form an organization (similar to a trade union) to protect their rights and advance their economic status. The Amendment grants a franchisee organization, composed of franchisees with the same trade dress, the right to request consultation on transaction terms, including modification of a franchise agreement, with the franchisor, while obligating the franchisor to accept such request. Meanwhile, under the Amendment, the franchisor shall not penalize franchisees on the grounds that they have formed, have been admitted to, or have been involved in the activity of a franchisee organization. In the event of violation of the foregoing, the franchisor may be subject to corrective measures or a fine (Articles 14-2, 33 and 35).

Other Provisions – Repeal of Exclusive Right of Complaint

Under the pre-amendment Franchise Act, certain criminal violations of the Franchise Act could be prosecuted only when the Korea Fair Trade Commission ("KFTC") had filed a complaint, and the Prosecutor General had the exclusive right to request the KFTC to file such complaint. The Amendment, however, grants such right to the Chairman of the "Board of Audit and Inspection" (a governmental watchdog) and to the head of the "Small and Medium Business Administration" (a quasi-governmental body in charge of promoting SMEs). When so requested, the KFTC is required to file a criminal complaint (Article 44).

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Recently, the sudden increase in the number of franchise brands and franchisors has meant a corresponding increase in the number of disputes involving franchisees and domestic franchisors. In those disputes, franchisees, often small businesses and individuals, are prone to suffer unfair consequences. This situation has affected Korean society to such a point that lawmakers have decided to revise the Franchise Act as summarized above in an effort to protect franchisees from franchisors' unilateral and unfair transaction practices.

Operating a franchise in Korea requires the understanding of the circumstances which led to the revision of the Franchise Act and the reinforcement of the franchisee's protection in the Amendment. Further, one will need to review existing franchise agreements and the relationship with franchisees based on the terms of the Amendment, to ensure that one will remain in compliance with the Franchise Act. However, until the Presidential Decree specifying the details of the enforcement of the Amendment, a number of questions will remain unanswered.

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MITIGATING FCPA EXPOSURE IN INTERNATIONAL FRANCHISE AND DISTRIBUTION RELATIONSHIPS

By Michael E. Burke

Mitigating the risk of sanctions under the U.S. Foreign Corrupt Practices Act (FCPA) is a core concern in every international commercial transaction, including cross-border distribution and franchising relationships. The FCPA contains both anti-bribery and accounting provisions. The anti-bribery provisions prohibit U.S. persons and businesses, U.S. and foreign public companies listed on stock exchanges in the United States or which are required to file periodic reports with the Securities and Exchange Commission, and certain foreign persons and businesses acting while in the territory of the United States from making corrupt payments to foreign officials to obtain or retain business. The accounting provisions require issuers to make and keep accurate books and records and to devise and maintain an adequate system of internal accounting controls. The U.S. Department of Justice and the Securities and Exchange Commission share enforcement authority under the Act. This article will review briefly best practices to mitigate FCPA risk in the international distribution and franchising space.

The FCPA expressly prohibits corrupt payments made directly to foreign government officials as well as corrupt payments made through third parties or intermediaries. More specifically, the statute prohibits payments made to "any person, while knowing that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly," to a foreign official. The fact that a bribe is paid by a third party does not eliminate the potential for criminal or civil FCPA liability for the U.S. principal. The key to the statute's wide jurisdictional reach is in the definition of "knowing": a person's state of mind is "knowing" with respect to conduct, a circumstance, or a result if the person: (i) is aware that he or she is engaging in such conduct, that such circumstance exists, or that such result is substantially certain to occur; or (ii) has a firm belief that such circumstance exists or that such result is substantially certain to occur.

The statute's expansive jurisdiction thus provides that principals can be found liable for their distributor's or franchisee's violations of the statute. While there are many reported FCPA investigations and enforcement actions involving international distribution relationships, no investigations or enforcement actions (as of yet) have focused on international franchising relationships. Franchisors, however, should not believe that they are exempt from the FCPA's antibribery or recordkeeping requirements. The expansive construction and interpretation of the language "to obtain or retain business or secure an improper business advantage" strongly suggests that a franchisee's improper or illegal activity (as with a distributor) can expose the franchisor to FCPA liability.

Companies using distributors or franchisees outside the United States must conduct risk-based due diligence in order to mitigate their FCPA risk exposure. This diligence includes both an initial review of the potential distributor or franchisee before any agreement is executed and ongoing oversight once the agreement is in place. Further, the diligence should account for the industry, country, size and nature of the transaction, and historical relationship with the distributor or franchisee. Transparency International's Corruption Perception Index is a great resource for understanding which jurisdiction, and which sectors within a jurisdiction, present higher corruption risk. Companies should also catalogue the points at which their business operations interact with non-U.S. government officials—the greater the number of contact points, the more robust the compliance program should be.

At its most basic level, a compliance program should focus on three principles: (i) understanding the qualifications and associations of a potential distributor or franchisee, including its business reputation, and relationship, if any, with foreign officials: (ii) understanding the business rationale for engaging the potential distributor or franchisee; and (iii) undertaking some form of ongoing monitoring of the distribution or franchise relationship. Effective diligence, even if it fails to detect 100% of a distributor's or franchisee's corrupt behavior, will be a mitigating factor in determining a company's penalty for FCPA violations by its distributor or franchisee. An effective FCPA compliance program also requires a mechanism to allow employees and others to report suspected or actual misconduct; importantly, a good compliance program should constantly evolve to reflect a company's operations or changes in relevant law or regulation.

The initial review of each potential franchisee or distributor should seek to answer a number of questions, including: Does the government or any official or instrumentality of the government have any ownership or other financial interest in the distributor or franchisee (keeping in mind the expanding definition of government instrumentality under the FCPA)? Has the distributor or franchisee ever been charged with any sort of crime, fraud or bribery? Is the distributor or franchisee qualified to perform the duties for which it may be engaged? Does the distributor or franchisee rely heavily on political or government contacts as opposed to knowledgeable staff? If the initial due diligence review reveals any red flags, the U.S. principal/franchisor should resolve them before entering into any agreement. If there is an FCPA issue down the road, and if a due diligence investigation revealed red flags that were not resolved, or were ignored prior to entering to an agreement, it will be an aggravating factor in assessing the principal/franchisor's liability and/or possible penalty.

U.S. principals and franchisors should include specific FCPA-compliance language in every distribution or franchise agreement. Such language should require the distributor or franchisee to (i) acknowledge the FCPA's parameters and restrictions; (ii) agree to abide by the FCPA's restrictions and requirements, as well as related local law restrictions and requirements; (iii) allow the principal to conduct FCPA compliance-focused audits on the supplier on a periodic basis; (iv) acknowledge, and agree to conform to, the principal's FCPA compliance program; (v) agree to provide semi-annual certifications as to FCPA compliance; and (vi) allow the principal to terminate the agreement immediately and without penalty (if possible under local law) in the event of an FCPA breach by the distributor or franchisee. In addition, indemnification clauses should require that the distributor or franchisee reimburse the purchaser not just for any "losses," but specifically for the principal's costs of an FCPA investigation.

During the agreement's performance, the U.S. principal/franchisor should monitor its partners by investigating the following questions: Have any unusual payment patterns or financial arrangements emerged? Any payments in cash or cash equivalent? Any payments to an offshore account? Is the compensation rate substantially above the going rate for similar work in a particular country? The principal/franchisor also should follow up on any reasonable rumors that suggest corrupt activity by the distributor or franchisee.

One final suggestion: U.S. principals and franchisors should keep their company's FCPA compliance policy up-to-date, and train those employees who oversee distributors or franchisees or otherwise have an 'international' portfolio in FCPA compliance.

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FRANCHISING IN AMERICA: REPRESENTING FOREIGN FRANCHISORS ENTERING THE U.S. MARKET

By Michael R. Daigle

The US is one of more than 30 countries that specifically regulate franchising in some manner. Regulated at the federal level since 1979 and, currently, in nearly half of the 50 states and the nation's capital, franchising in the US is governed by a web of federal and state laws, regulations and jurisprudence that comprise arguably the most detailed, extensive, complex and, some would say, intrusive regulatory scheme of all the regulating countries. Advising franchisors entering the US market can be challenging, frustrating and fraught with traps for unwary franchisors and their counsel.

The Definitional Threshold

To be captured under the various franchise laws, what is being offered or sold must, of course, be a "franchise" as that term is defined under those laws. Because there are definitional variations within the various regulatory schemes, if what is being offered contains one or more of three key elements, it *might* be considered a "franchise": (1) association with a trademark, (2) payment by the franchisee of a fee, and (3) the exercise of significant control or provision of significant assistance in the operation of the business. If one or more of these elements is present, further exploration of the definition of a "franchise" under each potentially applicable regulatory scheme is critical as variations and nuances do exist. For example, one or more states' laws may require the presence of only two of the three elements; the "franchisor" may not actually have to own a mark that it represents it will license or have the means to provide the assistance that it represents it will provide; and whether payment of money constitutes payment of a "fee" might depend on the amount, nature and timing of the payment. In short, the definitional threshold is, in some sense, a moving target – what falls short of being considered a "franchise" under the federal definition, for example, may very well be a "franchise" under one or more of the regulating states' definitions.

Franchise Sales - The Basics

At the federal level, the Federal Trade Commission's rule on *Disclosure Requirements and Prohibitions Concerning Franchising* (16 CFR Part 436) (the "FTC Rule") is, in its purest form, a pre-sale disclosure rule. No registration of the franchisor, the disclosure document or the franchise program is required at the federal level, but the FTC Rule applies generally to all franchises offered where either the franchisee resides or the franchised business is to be conducted in the US. The FTC Rule is generally satisfied merely by the franchisor's timely provision to a prospective franchisee of a complete and accurate franchise disclosure document or "FDD."

Many individual states have adopted their own regulatory schemes which, in addition to the FTC Rule, will apply to transactions that satisfy the jurisdictional requirements of the particular state's laws. Typically, these jurisdictional thresholds include one or more of (a) the offer or sale being made in the state, (b) the franchisee residing in the state, and/or (c) the franchised business being conducted in the state. Some states' laws will only regulate certain aspects of the franchise relationship (most, as discussed below, focused on the franchisor's ability to terminate or non-renew a franchise). Fourteen states, however, regulate the offer and sale of franchises in their states. Those states, like the FTC Rule, require that the franchisor timely provide the prospective franchisee with a complete and accurate FDD (note, however, that - probably not surprisingly – there is variation in what is considered "timely" and what constitutes a complete and accurate disclosure document). Importantly, those 14 states add to the existing disclosure obligation a requirement to register the FDD prior to offering or selling franchises in the state. In some of the regulating states, registration is effective on filing, but in others, the proposed FDD is reviewed by an examiner and is awarded registration only after the examiner is satisfied that the FDD complies with the state's regulatory requirements. This review process can present both substantive and logistical challenges as changes are made to the documents to comply with state differences and, in some cases, to address the peculiarities of the particular state examiner.

Five Tips

- ***Reading the disclosure laws is not enough***. The FTC Rule and the various state disclosure laws are readily available via the internet. Reading and understanding them is a necessary first step, but stopping

there will provide an incomplete picture. First, as noted above, some states regulate only the franchise relationship, some regulate only the required pre-sale registration and disclosure obligation, and still others regulate both. Second, like Canada, Australia and many other countries that regulate franchising, the pre-sale registration and disclosure laws in the US are backed by a series of regulations and guidance which must also be reviewed. Most states give the administrator of its laws (typically, the state's Attorney General, Department of Corporations, or Secretary of State) latitude to determine how the state's registration and disclosure laws will be implemented. This has resulted in specific regulations applicable to franchising in that particular state, which may include interpretations of specific provisions of the laws, the requirement to use specific forms, and rules relating to fees and timing of filings. Examination of and familiarity with these regulations is a critical step in the process since they often lead to differing and, sometimes disparate requirements from state to state. Third, preparation of the FDD is aided by a Compliance Guide adopted by the Federal Trade Commission, which administers the FTC Rule (the "Commission"), and by a compliance guide adopted by the North American Securities Administrators Association, Inc. ("NASAA") as a model for states with specific franchise registration and disclosure laws. Both NASAA and the staff at the Commission periodically issue responses to questions posed with respect to the FTC Rule ("FAQs"). Responses to FAQs, while not binding on the Commission or on the regulating states or rising to the level of official revisions to the FTC Rule or state regulations, are generally relied upon by state examiners when reviewing FDDs for registration in their respective states. Finally, judicial interpretations of both the FTC Rule and the various state requirements will provide critical on-going guidance in the drafting of FDDs and form agreements used by the franchisor.

- ***Look for exemptions***. Though not always the case, franchisors who are stepping into international development are often doing so only after having established themselves, with some degree of success, in their home countries either by operating their own units or having a history of having granted franchises. Anecdotally, this appears lately to be much more the case with in-bound franchisors than with out-bound franchisors, but it often means that the foreign franchisor has attained a certain size or experience and is seeking master franchisees or area developers that are also of a certain size and experience. This information can be important in deciding with which obligations the franchisor must comply. The FTC Rule does provide for certain exemptions generally based on the size of the initial investment (the "large franchise"), the size/sophistication of the franchisee (the "sophisticated franchisee"), the size of the franchised business in relation to the revenue generated by the franchisee's other businesses (the "fractional franchise") and the single trademark license. Several regulating states have also adopted exemptions, but there are three critical differences: first, not all of the exempt categories under the FTC Rule are also exempt under each state's laws; second, the exemption typically applies to the obligation to register, not the obligation to provide pre-sale disclosure; and, third, the franchisor is often required to file a notice of exemption with the state regulatory body.

- ***Beware of special industry laws***. Depending on the nature of the franchised business, there might be laws applicable to that specific industry that would apply, either in place of or in addition to the FTC Rule or state disclosure laws. For example, the FTC Rule has a specific exemption that applies to gasoline station franchises where the petroleum marketers and resellers are covered by the Petroleum Marketing Practices Act. Various states have also adopted other special industry laws relating to franchises ranging from beer distributors to farm equipment distributors to automobile sellers. Typically these special industry laws are relationship statutes, regulating the franchisor's ability to terminate or refuse to renew the franchise, but if the franchise system at issue is in one of these "special industries," it will be critically important to become familiar with these special industry laws.

- ***Beware of business opportunity laws***. At times, franchisors will attempt to structure their systems such that they fall outside the reach of the FTC Rule or state franchise laws, usually by eliminating one or more of the elements which define a "franchise" as discussed above. However, in doing so, they typically find themselves mired in what could be an even more cumbersome scheme regulating the offer and sale of business opportunities both under the Federal Trade Commission's recently adopted Business Opportunity Rule (16 CFR Part 437) and under 26 different state regulations pertaining to the offer and sale of business opportunities. Of the 26 business opportunity states, 10 are among the states that also regulate franchises, and their franchise registration and disclosure obligations will control. The remaining 16 states provide exemptions where (a) the business opportunity involves a licensed

trademark (in most, but not all cases, the trademark registration must be a federal, not a state, registration), and (b) the seller of the business opportunity complies with the pre-sale disclosure obligations under the FTC Rule. Given the exemption, most franchisors with a federally registered trademark need not be concerned with the business opportunity laws. These laws are important, however, in a couple of respects. First, some states require either a one-time (Texas, for example) or an annual (Florida, for example) notice filing with a designated state agency. Second, if they apply, the business opportunity states would generally require the business opportunity seller to register with the state, provide prospective purchasers with a pre-sale disclosure document, and, in some cases, post a bond with the designated state agency. Notably, unlike the state franchise laws, the various business opportunity laws do not necessarily have the same degree of consistency from state to state, making it difficult, if not impossible, to create one multi-state document that would work for all business opportunity states as is possible under the franchise regulatory schemes.

- ***Be mindful of the requirement to update registrations and disclosure documents***. Franchisors are generally required to update their registrations and FDDs on an annual basis and sooner in the event of the occurrence of a material event. Under the FTC Rule, franchisors are required to update to capture material events on a calendar quarterly basis and to complete their annual renewal within 120 days following the end of their fiscal year. The regulating states have similar requirements, but the varying speeds at which they have revised their regulatory schemes to be consistent with the FTC Rule have resulted in a patchwork of obligations requiring franchisors to capture material events in some states as soon as a "reasonable time" or a specified number of days (30 days, for example) after the occurrence of a material event and to renew their state filings within 90 days following the end of their fiscal year. How important these requirements are will depend, in large part, on how the franchisor approaches development in the US. Franchisors in the US are under no continuing obligation to provide an existing franchisee with an updated FDD, so for franchisors who grant to a single master franchisee the rights to all of the US, this may be a non-issue, at least until a transfer or renewal of the agreement which, in either case, is conditioned upon the execution of the franchisor's then-current form of agreement. On the other hand, if the franchisor is granting one or more area development deals where each unit would be subject to an individual franchise agreement signed by the franchisor and franchisee as the unit is being developed, the execution of each new franchise agreement will be considered the grant of a new franchise subject to all requirements applicable thereto, thus requiring the franchisor to maintain a current registration and FDD.

Conclusion

Given the size of the market and Americans' general acceptance of franchising as a method of distribution, the US presents tremendous opportunities for foreign franchisors despite what might appear to be an overly competitive and highly developed landscape. Taking advantage of those opportunities will require that franchisors and their counsel be familiar with and work within the web of intricate laws and regulations created by a two-tiered regulatory scheme - daunting, but definitely doable and, with the right approach, worth the effort.

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