

GETTING THE DEAL THROUGH®

Franchise

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Overview

- 1 What forms of business entities exist that would be relevant to the typical franchisor?

Although civil and mercantile partnerships can be utilised, the forms most utilised in order of preference for undertaking franchise operations in Puerto Rico are corporations, limited liability companies and limited liability partnerships.

The franchisor would have to determine if it needs to establish a business entity or register its existing entity in Puerto Rico in view of the actual operations it will undertake, since the mere contracting with a franchisee, that is a bonafide independent contractor, would not require establishing or registering an entity in Puerto Rico. The operations would also not be subject to Puerto Rico tax if title to goods sold pass outside Puerto Rico and the franchisor has no office, inventory or employees in Puerto Rico, and its employees visit Puerto Rico sporadically during the year.

- 2 What laws and agencies govern the formation of business entities?

The following laws are relevant:

- the General Corporation Act of 1995 (Act No. 144 of 10 August 1995), 14 PR Laws Ann section 201 et seq;
- the Limited Liability Companies Act (Act No. 487 of 23 September 2004), 14 PR Laws Ann section 3426 et seq; and
- the Limited Liability Partnership Act (Act No. 154 of 20 August 1996), 10 PR Laws Ann section 1861 et seq.

The agency governing the formation of these business entities is the Puerto Rico Department of State.

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

These laws are patterned on the various Delaware laws and so the requirements for forming and maintaining these three principal types of entities are familiar to persons who have established operations in one of the states of the US. In general, one can either establish the entity under the laws of Puerto Rico or register a non-Puerto Rico entity.

In order to establish the entity under the laws of Puerto Rico, the franchisor should file articles of incorporation, a certificate of formation of the limited liability company, or deed of constitution of partnership with names that do not conflict with business entities already registered with the Puerto Rico State Department.

To register a foreign corporation, limited liability company or limited liability partnership, the franchisor would file a statement to do business and provide a certificate of existence from the appropriate agency where the foreign entity is registered.

Establishing the entity under the laws of Puerto Rico and registering a foreign entity generally involves the filling out of a one- to two-page document with basic information on the entity and the designation of a resident agent with a physical address in Puerto Rico for the service of legal process. The one exception is the limited liability partnership, which requires a public deed if established in Puerto Rico and a copy of the foreign partnership agreement if it is registered.

The filing fees are normally US\$100 or less and the registration process will normally take two to three days.

Annual reports must be filed each year with filing fees of US\$100.

In addition to the filing with the Puerto Rico State Department, business entities and sole proprietors doing business in Puerto Rico must register by 15 July with the Puerto Rico Trade and Export Company (no filing fee is required) as well as with the Puerto Rico Treasury Department and various labour and employment-related agencies.

- 4 What restrictions apply to foreign business entities and foreign investment?

There are no particular restrictions that apply to foreign entities and foreign investments in Puerto Rico that are not generally applicable to Puerto Rico entities. As happens in most countries, there are lines of business such as banking and insurance, as well as professions that are especially regulated or require special licences, but these are not areas in which franchises are normally involved.

Puerto Rico is part of the US, and so US import, export and immigration laws and regulations are generally applicable to entities investing or doing business in Puerto Rico.

- 5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Federal taxation

Puerto Rico is considered a foreign country for US tax purposes; thus, the US Internal Revenue Code (IRC) generally does not apply to Puerto Rico operations. However, US citizens residing in Puerto Rico, including those born in Puerto Rico, although generally exempted by the IRC from income taxes on Puerto Rico-sourced income, are subject to US tax on most US- and foreign-sourced income.

Puerto Rico tax laws

Income tax

The Puerto Rico Income Tax Act is based on the IRC. All natural and juridical persons having Puerto Rico-sourced income are subject to Puerto Rico income tax on that income, unless expressly exempted. Resident individuals (those domiciled in Puerto Rico) are taxed on their worldwide income. Non-residents are taxed only on

Puerto Rico-sourced income and income effectively connected with the conduct of a trade or business in Puerto Rico (ECI). Normally, non-Puerto Rico-sourced income is not ECI. However, such income is considered ECI if the non-resident corporation or partnership has an office or branch in Puerto Rico and the foreign source income is attributable to the Puerto Rico office and consists of royalties on intangibles derived from the active conduct of such Puerto Rico business, dividends, interest or gain or loss from sale of securities in a banking or finance business or income received by the business from trading securities for its own account, and income received from the sale of goods outside of Puerto Rico through the Puerto Rico office (unless the goods are sold for use, consumption or disposition outside of Puerto Rico). Resident foreign corporations or partnerships (those not organised in Puerto Rico but engaged in trade or business here) are taxed on all ECI.

Income tax rates

Individuals, trust and estates

Taxable income	Rate
US\$17,000 or less	7%
Portion over US\$17,000 but not over US\$30,000	14%
Portion over US\$30,000 but not over US\$50,000	25%
Portion over US\$50,000	33%

Taxable income brackets are reduced by 50 per cent in the case of married taxpayers filing separately. Adjusted gross incomes (AGI) are reduced by 50 per cent if married taxpayer computes tax separately. For taxable years commencing after 31 December 2007, married individuals living together and both working may opt to determine tax liability on separate spouse basis or as single taxpayers. A five per cent add-on tax applies to income in excess of US\$75,000 (US\$37,500 in the case of married taxpayers filing separate returns). The tax is limited to an amount that will result in a flat tax, at the maximum rate in effect, on the taxpayer's entire taxable income increased by taxpayer's personal and dependent exemptions. Tax on individuals is the higher of regular tax or alternate base tax (ABT). ABT applies only to AGI over US\$75,000. ABT rates are as follows:

Tax bracket	Rate
US\$75,000 to US\$125,000	10%
US\$125,000 to US\$175,000	15%
Over US\$175,000	20%

AGI levels are reduced by 50 per cent in the case of married taxpayers filing separately.

Net long-term capital gains are subject to a tax rate of 10 per cent, but the taxpayer may elect the regular rate if lower.

There are also alternate special taxes to take into account. Dividend and profit distributions by Puerto Rico corporations and partnerships and by foreign corporations and partnerships whose Puerto Rico source income or ECI is at least 80 per cent of the gross income of such foreign corporation or partnership for the prior three taxable years, are taxed at a 10 per cent tax rate.

An alternate tax of 10 per cent applies to non-exempt interest credited on interest bearing deposits (or those registered with a brokerage house as nominee) in certain local financial institutions or that is paid or distributed by an individual retirement account.

An alternate tax of 10 per cent is imposed on non-exempt interest on obligations issued by Puerto Rico corporations or partnerships or by foreign corporations or partnerships whose Puerto Rico source

income or ECI is at least 80 per cent of the gross income of such foreign corporation or partnership for the prior three taxable years. This 10 per cent alternate tax also applies to non-exempt interest on certain residential Puerto Rico mortgages.

The individual may elect to have normal tax rates apply if such tax rates turn out to be more beneficial than the alternate tax rates.

Non-resident US citizens are taxed at the same rates as residents on their Puerto Rico source income. However, certain items of Puerto Rico source income are subject to a 20 per cent withholding tax, except that on sales of Puerto Rico property the withholding rate is 12.5 per cent.

Non-resident non-US citizens not engaged in business are taxable at a flat 29 per cent tax on Puerto Rico-sourced fixed or determinable annual or periodic income and on net Puerto Rico-sourced capital gains. Withholding at source at 29 per cent applies to all payers of such income, except that in case of sales of real estate or shares of stock by a non-resident non-US citizen, buyer withholds 25 per cent of sales price (net of original cost).

The net income of an estate or trust shall be computed in the same manner and on the same basis as in the case of individuals, with the exception to allowable deductions for charitable contributions and additional deductions for certain distributions to legatees, heirs or beneficiaries.

Corporations and partnerships

For tax purposes, Puerto Rico treats partnerships the same as corporations and partners are not taxed on undistributed partnership profits. Corporations and partnerships are subject to a tax rate of 20 per cent on net income. For foreign corporations, the tax applies to net ECI. Also, to the extent the corporation's net income exceeds US\$25,000, it will be subject to additional income taxes at the following rates:

Income subject to additional taxes	Additional tax rate
US\$25,001 to US\$75,000	5%
US\$75,001 to US\$125,000	US\$3,750 plus 15% of the excess over US\$75,000
US\$125,001 to US\$175,000	US\$11,250 plus 16% of the excess over US\$125,000
US\$175,001 to US\$225,000	US\$19,250 plus 17% of the excess over US\$175,000
US\$225,001 to US\$275,000	US\$27,750 plus 18% of the excess over US\$225,000
Over US\$275,000	US\$36,750 plus 19% of the excess over US\$275,000

An additional five per cent tax applies to net ECI-PR in excess of US\$500,000, until the total taxable income is taxed at the maximum rate of 39 per cent, which is at US\$905,000.

Unless otherwise exempt, all corporations and partnerships are also subject to an alternate minimum tax (AMT) equal to 22 per cent of alternative minimum taxable income (AMTI). The tax liability is the greater of AMT or the regular tax liability. AMTI is calculated by making various adjustments to the regular taxable income, which have the effect of accelerating recognition of income.

Net long-term capital gains are taxed at 15 per cent. An alternate tax of 10 per cent is imposed on non-exempt interest on obligations issued by Puerto Rico corporations or partnerships or by foreign corporations or partnerships whose Puerto Rico-sourced income or ECI is at least 80 per cent of the gross income of such foreign corporation or partnership for the prior three taxable years. This 10 per cent alternate tax also applies to non-exempt interest on certain residential Puerto Rico mortgages.

Entities with gross income of no more than US\$5 million are subject to a 30 per cent flat income tax rate (25 per cent in certain cases). Such entities are not subject to graduated surtax and are allowed:

- current deductions for the cost of computers used in business, accelerated depreciation for certain motor vehicles and environmental conservation equipment;
- deductions from gross income of 50 per cent of self-employed tax; and
- deductions for health insurance premiums for self-employed and families.

This treatment will be effective for taxable years commencing after 31 December 2008.

Foreign corporations and partnerships engaged in trade of business in Puerto Rico are taxed on net ECI at the same rates as domestic corporations. If these companies derive less than 80 per cent of their gross income from Puerto Rico sources for the three-year period ending with the taxable year, they are also subject to a 10 per cent branch profits tax. This tax is imposed on after-tax earnings which are not reinvested (the dividend-equivalent amount) of the company's Puerto Rico branch.

Foreign corporations not engaged in trade or business in Puerto Rico are generally taxed on fixed or determinable gross income at 29 per cent to the extent amounts so received are considered to be from sources within Puerto Rico. Exceptions are dividends and partnership profit distributions which are taxed at 10 per cent. Certain royalties for use of industrial intangibles are also taxed at two per cent or 12 per cent. Gains derived from sources within Puerto Rico from sales or exchanges of capital assets which exceed losses allocable to sources within Puerto Rico from such sales or exchanges are subject to a 29 per cent tax. Interest on Puerto Rico bank deposits, real property mortgages constituted before 1 July 1995, and interest received from unrelated persons is exempt. Foreign tax credits against Puerto Rico tax are allowed for foreign taxes paid on non-Puerto Rico-sourced ECI. Deductions and credits attributable to Puerto Rico income are allowed only upon filing Puerto Rico income tax return reflecting income received from all sources. Credit is allowed for taxes withheld at source.

Municipal taxes and property taxes

A municipal licence tax is imposed on the gross receipts of the business conducted in a municipality. The tax rate cannot exceed 1.5 per cent for a financial business and 0.05 per cent in the case of all other types of businesses.

Construction tax on new construction and demolition is imposed by some municipalities based on the cost of the work. Tax rates vary depending on the municipal ordinance pursuant to which the construction tax is imposed.

Property tax on real and personal property is payable to the Municipal Revenue Collection Center (CRIM). There are 78 municipalities and municipal property tax rates vary, so that total combined rate ranges from US\$5.08 to US\$8.23 per US\$100 of reported value of personal property and US\$7.80 to US\$10.23 per US\$100 of assessed value of real property for fiscal year 2008–2009. Personal property is self-assessed by the taxpayer. Real property is assessed by CRIM based on 1957/58 fiscal year values, well below present market values.

A municipal sales and use tax of 1.5 per cent is imposed by most municipalities on the retail sale, use, consumption or storage of a taxable item in a particular municipality. The municipal sales tax on taxable items must be paid by the consumer at the time of sale. Taxable items include tangible personal property, taxable services, admission fees, and bundled transactions.

Licences, sales, use and excise taxes

Licences

Licenses are required for the sale of cigarettes, vehicles and parts, gasoline, jewelry, cement, and guns and ammunition.

Sales and use tax

A general sales and use tax of 5.5 per cent is imposed on the retail sale, use, consumption or storage of a taxable item in Puerto Rico. The general sales tax on taxable items must be paid by the consumer at the time of sale. Taxable items include tangible personal property, taxable services, admission fees, and bundled transactions.

Excise tax

Special excise taxes apply upon the introduction, sale, consumption, use, transfer or acquisition of cement, cigarettes, petroleum products, vehicles, alcoholic beverages and on plastic products manufactured outside Puerto Rico that do not comply with certain specifications.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

A typical franchisor would not have an office or employees resident in Puerto Rico, but would send employees sporadically to meet with the franchisee and ensure compliance with the franchise agreement in order to ensure that its trademarks, goodwill and reputation are enhanced and not adversely affected by the franchisee's operations. This typical franchisor would not have to comply with the Puerto Rico labour and employment laws.

Assuming the franchisor maintains its independence from the franchisee in the day-to-day operations so that the franchisee is deemed a bona fide independent contractor, the employees of the franchisee would not be deemed employees of the franchisor. In this regard, the franchisor should not be involved in the supervision and administration of the franchisee's employees.

7 How are trademarks and know-how protected?

Under the trademark laws of the US and Puerto Rico, the principal method of establishing rights in a trademark is actual use of the trademark. Registration of a trademark is not legally required but can provide distinct advantages and is highly recommended. Registration of a trademark is prima facie evidence of ownership. Infringers are subject to one or more of injunction, actions for damages or seizure orders.

Registration in the US Patent and Trademark Office protects marks used in interstate commerce in Puerto Rico but not in some situations where infringement is strictly intrastate. In addition, local registration offers various procedural advantages in the protection of a trademark so that both US and local registration is recommended.

Registration of a trademark in Puerto Rico is accomplished by filing an application with the Puerto Rico secretary of state together with a sworn statement as to the applicant's right to use the mark, facsimiles of the mark as used or proposed to be used, and payment of a US\$150 fee. Applicants are also required to provide facsimiles of the mark as used, or proposed to be used, in commerce. Registration is valid for 10 years from the filing date and may be renewed for successive 10-year periods thereafter, provided that the owner of the mark files a sworn statement of use within five years of the application filing date, otherwise the registration lapses.

The following marks may not be registered in Puerto Rico:

- i any mark contrary to the law;
- ii any mark containing the flag, coat of arms or other insignia of Puerto Rico, of the US or of any state, municipality or nation, or an imitation thereof;
- iii a person's name, nickname, picture or signature, unless consent is obtained;
- iv words descriptive of products or services with which the mark is used;
- v words indicating the type, nature or physical appearance of the product or service;
- vi geographical names or terms indicating the origin of the product or services;
- vii any mark that is identical to another registered or known mark used for the same type of product or service;
- viii any mark so similar to another that its use will cause confusion or deception in the public mind; and
- ix any mark that is identical or similar to a registered or pending registration mark, that is likely to cause confusion or error in the public's mind.

As an exception to points (iv), (v) and (vi), such marks may be registered if they have acquired a distinctive character through the use they have been given for the products or services for which registration is requested.

Trade secrets or know-how are not protected by specific statute. However, Puerto Rico general tort and property law as well as the unfair competition statutes and regulations may be used to protect trade secrets. Also, rule 23.2(g) of the Puerto Rico Rules of Civil Procedure allows protective orders to prevent disclosure of trade secrets.

8 What are the relevant aspects of the real estate market and real estate law?

There are no special restrictions or conditions applicable to foreign franchisors as compared to domestic ones. Real estate is governed by the Civil Code and the Mortgage Act that come via Spain. There are no special or surprising aspects of the real estate market and real estate laws applicable to franchisors with the exception of what is described below respecting the consequences of not recording real estate interests.

The most relevant aspect of Puerto Rico real estate law is the concept that in order to be protected in terms of third parties, the lessee needs to have its real estate interest recorded in the registry of property; otherwise, the lessee would only have a contractual cause of action against the lessor should the property be sold. In order to have access to the registry of property, the real estate interest needs to be incorporated in a public deed before a Puerto Rico notary public. The fees for the public deed and recordation are approximately US\$5.50 per thousand of valuation, except that for the recordation fee portion (US\$4 per thousand) the valuation is limited to the first 12 years. In addition, there is a mandatory notary public fee equal to 1 per cent of the lease value up to US\$500,000 and 0.5 per cent of the lease value between US\$500,000 and US\$10 million. To the extent the lease value exceeds US\$10 million, then the parties can agree on the notary fee for such excess value.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

Puerto Rico law does not specifically define franchise. The Puerto Rico Dealers' Contracts Act (Law No. 75 of 24 June 1964), 10 PR Laws Ann section 278 et seq (Act 75), enacted principally to govern

dealerships, refers generally to the concept of franchise when defining 'dealer's contract' as a '[r]elationship established between a dealer and a principal or grantor whereby and irrespectively of the manner in which the parties may call, characterize or execute such relationship, the former actually and effectively takes charge of the distribution of a merchandise, or of the rendering of a service, by concession or franchise, on the market of Puerto Rico' (id section 278(b)).

Act 75 defines 'principal' generally as a '[p]erson who executes a dealer's contract with a dealer' (id section 278(c)), and it includes grantors and franchisors. For Act 75's definition of 'dealer', see question 12.

10 Which laws and government agencies regulate the offer and sale of franchises?

No local laws or government agencies regulate the offer or sale of franchises in Puerto Rico. As a US territory, however, Puerto Rico is generally subject to US laws and regulations, including the Federal Trade Commission Franchise Rule.

11 Describe the relevant requirements of these laws and agencies.

See answer to question 10.

12 What are the exemptions and exclusions from any franchise laws and regulations?

Act 75 applies to dealers, defined as a '[p]erson actually interested in a dealer's contract because of his having effectively in his charge in Puerto Rico the distribution, agency, concession or representation of a given merchandise or service' (10 PR Laws Ann section 278(a)). The Puerto Rico Supreme Court, however, has established several factors to consider in determining whether someone may be deemed a dealer for purposes of Act 75; to wit, whether that someone:

- promotes and concludes contracts;
- acquires an inventory;
- exercises control over prices;
- has discretion to fix sales terms;
- has delivery and billing responsibilities;
- has authority to extend credit;
- independently or jointly embarks on advertising campaigns;
- has assumed the risks and responsibilities for the activities undertaken;
- buys the product; and
- has facilities, such as, a warehouse and offers product-related services. See *Roberco Inc v Oxford Industries, Inc*, 122 PR Dec 115, 131–32 (1988).

Not all of these factors need to be present for an intermediary to be deemed protected under Act 75. *Cobos Licia v DeJean Packing Co Inc*, 124 PR Dec 896, 907 (1989). Act 75 does not apply to brokers operating solely on a commission basis who do not have any of the responsibilities of a dealer. See *Roberco Inc*, 122 PR Dec at 127.

Act 75 is liberally interpreted in favour of those who carry out distribution activities, regardless of the corporate or contractual structures or mechanisms that a principal may have created or imposed to conceal the real terms of the established relationship (10 PR Laws Ann section 278c). Therefore, it is not the specific provisions of a contract, or, for that matter, whether or not a written contract exists, that will determine the rights and liabilities of the parties; rather, it is the course of dealing between the principal and the distributor. See *RW Int'l Corp v Welch Food Inc*, 13 F 3d 478, 483 (1st Cir 1994); *Homedical Inc v Sarns/3M Health Care Inc*, 857 F Supp 947, 951 (DPR 1995).

13 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?

See answer to question 10.

14 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

See answer to question 10.

15 What information must the disclosure document contain?

See answer to question 10.

16 How do the relevant government agencies enforce the disclosure requirements?

See answer to question 10.

17 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

See answer to question 10.

18 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?

See answer to question 10.

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

See answer to question 10.

20 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

A franchisor that engages in fraudulent or deceptive practices in connection with the offer and sale of franchises may incur liability under local and US law, such as the Racketeer Influenced and Corrupt Organizations Act, 18 USC section 1961 et seq. Under Puerto Rico law, a franchisor that engages in such practices or conduct may incur contract or tort liability or both.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

21 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

Act 75 was enacted to afford dealers (including franchisees) in Puerto Rico adequate protection from arbitrary termination by principals with

superior bargaining powers. See *RW Int'l Corp v Welch Food Inc*, 88 F 3d 49, 51 (1st Cir 1996). Under Act 75, a principal may not terminate, refuse to renew, impair or otherwise undermine its business relationship with a franchisee except for just cause, regardless of the manner in which the parties may refer to, characterise or establish the relationship, and notwithstanding any provision for a definite expiration term or clause allowing the parties to unilaterally terminate their relationship (see 10 PR Laws Ann sections 278a and 278(b)). Because of the strong public policy underlying it, Act 75 specifically provides that a franchisee cannot waive its statutory rights (see id section 278c).

22 Do other laws affect the franchise relationship?

The US antitrust laws, which apply in Puerto Rico, are primarily reflected in five federal statutes:

- the Sherman Act;
- the Clayton Act;
- the Robinson-Patman Act;
- the Federal Trade Commission Act; and
- the Hart-Scott-Rodino Act.

Except for the Hart-Scott-Rodino Act governing some mergers and acquisition that would not affect a franchise relationship, the other US laws have counterpart local statutes, and could apply to the franchise relationship such as, for example, unreasonable restrictions placed on the franchisee (Sherman Act), tying arrangements (Clayton Act), price discrimination or discriminatory advertising allowances (Robinson-Patman Act) and unfair or deceptive acts or practices (Federal Trade Commission Act). The first three US laws are closely tracked by the Puerto Rico antitrust law, Act No. 77 of 25 June 1964, 10 PR Laws Ann section 257 et seq, and the Federal Trade Commission Act is tracked by the law establishing the Department of Consumer Affairs, Act No. 5 of 23 April 1973, 3 PR Laws Ann section 341 et seq (as to unfair or deceptive acts or practices). There is also a local Office of Monopolistic Affairs (see 10 PR Laws Ann section 271 et seq).

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

No.

24 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?

Under Act 75, a franchisor may not terminate, impair or refuse to renew a franchise relationship except for just cause (see 10 PR Laws Ann section 278a). Act 75 defines 'just cause' generally as the 'non-performance of any of the essential obligations of the dealer's contract, on the part of the dealer, or any act or omission on his part that adversely and substantially affects the interests of the principal or grantor in promoting the marketing or distribution of the merchandise or service' (id section 278(d)). Act 75 focuses on the franchisee. Therefore, the acts or omissions constituting 'just cause' must be attributable to the franchisee. Except for extraordinary circumstances, such as when the principal completely withdraws from the market, '[t]he ups and downs of the principal play no part' in the determination of whether there exists 'just cause' for termination, impairment or non-renewal of the established relationship. *Medina & Medina v Country Pride Foods Ltd*, 858 F 2d 817, 821 (1st Cir 1988); see also *V Suárez & Co Inc v Dow Brands Inc*, 337 F 3d 1, 9 (1st Cir 2003).

The statutory definition of 'just cause' is broad and not particularly helpful, and there are not many judicial decisions addressing

what constitutes ‘just cause’. However, any determination of the issue must begin with an understanding of what are the express obligations of the franchisee and whether or not the franchisee’s failure to comply with those obligations could be justified by market conditions or other similar factors. The breach of a particular obligation will not necessarily satisfy the definition of ‘just cause’; the obligation breached must be determined to be essential (see *PPM Chemical Corp v Saskatoon Chemical Ltd*, 931 F 2d 138 (1st Cir 1991); *Bio-medical Instrument & Equipment Corp v Cordis Corp*, 797 F 2d 16 (1st Cir 1986)).

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

Act 75 does not govern termination or non-renewal of a franchise relationship by the franchisee. The circumstances in which a franchisee may terminate or fail to renew the relationship may be established in the franchise agreement, as long as they are not contrary to law, morals or public order (see 31 PR Laws Ann section 3372). A franchisee could also terminate a franchise relationship under the doctrine of *exceptio non adimpleti contractus*; that is, once a party fails to fulfil an essential obligation under the contract, the other party is no longer bound to comply with its reciprocal obligation (see 31 PR Laws Ann section 3052).

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

See answer to question 24.

27 May a franchisor restrict a franchisee’s ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

A franchisor may restrict a franchisee’s ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity only for just cause. In this regard, Act 75 provides that ‘[t]he violation or nonperformance by a dealer of any provision included in the dealer’s contract to... prevent or restrict the free sale, transfer or encumbrance of any corporate action, participation, right or interest that any person could have in said distribution business, shall not be considered as being just cause, unless the principal or grantor shows that such non-performance may affect, or has truly and effectively affected the interests of such principal or grantor in an adverse or substantial manner in the development of the market, distribution of the merchandise or rendering of services’ (see 10 PR Laws Ann section 278a-1(a)).

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

Other than withholding taxes on royalties (see question 5), there are no laws or regulations affecting the nature, amount or payment of fees.

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

There are no restrictions on the amount of interest that can be charged on overdue payments if the payor is a juridical entity. If the payor is an individual, then the conservative position is to limit the maximum interest to that provided by the Civil Code of eight per cent on amounts up to US\$3,000 and nine per cent if the amount exceeds US\$3,000 (see 31 PR Laws Ann section 4591; 10 PR Laws Ann section 998).

30 Are there laws or regulations restricting a franchisee’s ability to make payments to a foreign franchisor in the franchisor’s domestic currency?
No.

31 Are confidentiality covenants in franchise agreements enforceable?
As long as they are not contrary to law, morals or public order, confidentiality covenants in franchise agreements are enforceable (see 31 PR Laws Ann section 3372).

32 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?
All obligations must be performed in good faith (see 10 PR Laws Ann section 1308; 31 PR Laws Ann section 3375; *González v Sucn Cruz*, 163 PR Dec 449, 458 (2004)).

33 Must disclosure documents and franchise agreements be in the language of your country?
Spanish and English are official languages in Puerto Rico, except in local courts, where the proceedings must be conducted in Spanish (see 1 PR Laws Ann section 59; *Pueblo v Tribunal Superior*, 92 PR Dec 596, 606 (1965)). There is no requirement that franchise agreements be in Spanish or English. Of course, the agreement must be in a language known to the franchisee.

34 What restrictions are there on provisions in franchise contracts?
Act 75 establishes several restrictions that bear on the type of provisions that may be included in franchise contracts. Regarding the duration of the agreement, Act 75 prohibits termination and non-renewal except for just cause (see 10 PR Laws Ann section 278a). Just cause is also required for termination and non-renewal resulting from franchisee’s breach of a contract provisions restricting the franchisee’s ability to transfer its franchise or ownership interests in a franchisee entity (see id section 278a-1(a)). Provisions ‘fixing rules of conduct or distribution quotas or goals’ must be shown to ‘adjust to the realities of the Puerto Rican market at the time of’ the franchisee’s failure to comply with such rules or meet those quotas or goals, if that circumstance is to be invoked as just cause for termination or non-renewal (see id section 278a-1(c)).

Act 75 further declares void any provision in a franchise contract establishing a governing law other than the laws of the Commonwealth of Puerto Rico (see 10 PR Laws Ann section 278b-2).

As regards dispute resolution, Act 75 declares null and void any provision that would require a franchisee to arbitrate or litigate outside of Puerto Rico (see id section 278b-2). The US Federal Arbitration Act (FAA), 9 USC section 1 et seq, preempts Act 75’s bar against arbitration fora outside Puerto Rico in the case of franchise contracts involving interstate or international commerce (see *World Films Inc v Paramount Pictures Corp*, 125 DPR 352 (1990)). It is still an open issue, however, whether the FAA’s preemption extends as well to choice of law provisions within arbitration clauses that select the laws of jurisdictions other than Puerto Rico. This issue has been raised in some federal district court cases and the courts have decided that the issue of the applicable law should be referred to the arbitrator (see, for example, *Medika Int’l v Scanlan Int’l*, 830 F Supp 81, 87–88 (DPR 1993); *Protane Gas Co of PR Inc v Sony Consumer Products Co*, 613 F Supp 215, 218–19 (DPR 1985)).

Before giving effect to an arbitration provision in a franchise contract, Act 75 requires that a court ‘with jurisdiction in Puerto Rico’ determine that such provision ‘was subscribed freely and voluntarily by both parties’ (10 PR Laws Ann section 278b-3). Further,

Act 75 creates a controvertible presumption that any arbitration provision in a franchise contract ‘was included or subscribed at the request of the principal or grantor’ and ‘is an adhesion contract to be interpreted and made effective as such’ (id). As to whether these provisions will be upheld by the courts, quare.

Finally, Act 75 provides that a franchisee cannot contractually waive its statutory rights (see id section 278c).

35 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

US antitrust laws apply fully in Puerto Rico. There are also local laws in effect which are either identical or very similar to US antitrust laws (see answer to question 21).

36 Very briefly describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Puerto Rico’s court system is very similar to that of any of the states of the US. This system is composed of Commonwealth courts, which include courts of first instance, a Court of Appeals and a Supreme Court, and a US District Court for the District of Puerto Rico, whose decisions are reviewed by the US Court of Appeals for the First Circuit and the US Supreme Court.

Franchise disputes are brought in the US District Court for the District of Puerto Rico almost exclusively on the basis of diversity jurisdiction.

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