

Franchise

in 33 jurisdictions worldwide

2013

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Puerto Rico

Walter F Chow

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Overview

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

The most common type of entity for conducting franchise operations in Puerto Rico are corporations and limited liability companies.

A franchisor does not need to be authorised to conduct business in Puerto Rico in order to contract with a Puerto Rican franchisee. The franchisor should, nonetheless, evaluate if it needs to establish a local entity or register in Puerto Rico an existing entity, in view of the operations it will embark on in Puerto Rico.

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

The formation of corporations and limited liability companies is regulated by Act No. 164 of 16 December 2009, also known as the General Corporations Act. The Puerto Rico Department of State is the agency entrusted with governing the formation of these business entities.

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

The Puerto Rico statutes governing corporations and limited liability companies follow, in general, Delaware statutes.

In order to establish a Puerto Rican corporation or limited liability company, a franchisor must file a certificate of incorporation or a certificate of organisation, respectively, with the Department of State.

Foreign corporations and limited liability companies that are not organised under Puerto Rican laws are considered foreign entities. Foreign entities must be registered with the Puerto Rico Department of State in order to conduct business in Puerto Rico. To register a foreign corporation or a limited liability company, the franchisor must file the corresponding application and a certified copy of the certificate of existence document from the appropriate agency where the foreign entity is registered.

Domestic corporations and foreign corporations authorised to do business in Puerto Rico must file with the Department of State by 15 April of each year a corporate annual report that includes a balance sheet. Depending on the revenues of the corporation, the balance sheet will need to be compiled or audited by a certified public accountant licensed in Puerto Rico.

Domestic and foreign limited liability companies must pay an annual fee to the Department of State by 1 March of each year.

Fees apply to all the previously mentioned filings.

In addition to the filings with the Department of State, a person engaged in business in Puerto Rico must register themselves on or before 15 July of each year with the Merchants and Business Mandatory Registry of the Puerto Rico Trade and Export Company. Filings with the Puerto Rico Department of Treasury, municipalities and labour and employment-related agencies are also required.

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

There are no particular restrictions that apply to foreign business entities and foreign investments. Generally, foreign investors are not required to obtain government approval to invest in Puerto Rico; however, restrictions imposed by US federal legislation may apply to foreigners investing in particular industries (for example, communications).

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, in general, the US Internal Revenue Code (IRC) does not apply to Puerto Rican operations. US citizens residing in Puerto Rico, including those born in Puerto Rico, are generally exempted by the IRC from income taxes on Puerto Rican sourced income but are subject to US tax on most US and foreign-sourced income.

Puerto Rican tax laws

Income tax

The Puerto Rico Income Tax Act is based on the IRC. All natural and juridical persons with Puerto Rican sourced income are subject to Puerto Rican 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 Rican sourced income and income effectively connected with the conduct of a trade or business in Puerto Rico (ECI). Normally, non-Puerto Rican sourced income is not ECI. However, such income is considered ECI if the foreign corporation or partnership has an office or branch in Puerto Rico and the foreign-sourced income is attributable to the Puerto Rican office and consists of royalties on intangibles derived from the active conduct of such Puerto Rican business, dividends, interest or gain or loss from the 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 Rican office (unless the goods are sold for use, consumption or disposition outside 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 for taxable year 2012	Rate
US\$6,500 or less	0%
Portion over US\$6,500 but not over US\$23,000	7%
Portion over US\$23,000 but not over US\$41,300	14%
Portion over US\$41,300 but not over US\$61,300	25%
Portion over US\$61,300	33%

Taxable income for taxable year 2013	Rate
US\$9,000 or less	0%
Portion over US\$9,000 but not over US\$25,000	7%
Portion over US\$25,000 but not over US\$41,500	14%
Portion over US\$41,500 but not over US\$61,500	25%
Portion over US\$61,500	33%

Taxable income brackets and rates for taxable years commencing after 31 December 2013 are subject to compliance with fiscal responsibility tests (net revenues to the General Fund, expenditures and economic growth test).

Married individuals living together and both working filing jointly may opt to determine tax liability as individual taxpayers. A 5 per cent add-on tax applies to income in excess of US\$100,000, US\$200,000, US\$300,000 and US\$500,000 for taxable years 2011, 2012, 2013 and 2014, respectively (married taxpayers filing separate returns and married taxpayers filing joint returns, that so elect, determine the income level for purposes of the add-on tax in the same manner as an individual taxpayer). The add-on tax is eliminated for taxable years commencing after 31 December 2014. 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 the alternative minimum net taxable income over US\$150,000. ABT rates are as follows:

Alternative minimum net taxable income	Rate
US\$150,000 to US\$250,000	10%
US\$250,000 to US\$500,000	15%
Over US\$500,000	20%

Alternative minimum net taxable income levels are determined in the same manner as an individual taxpayer in the case of married taxpayers filing separate returns and married taxpayers filing joint returns that so elect. An alternative minimum tax foreign tax credit may be claimed against the ABT.

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

There are also special alternative taxes to take into account. Dividend distributions by Puerto Rican corporations and by foreign corporations whose ECI (that includes Puerto Rican sourced income) is at least 80 per cent of the gross income of such foreign corporation for the prior three taxable years, are taxed at a 10 per cent tax rate.

An alternative tax of 10 per cent applies to non-exempt interest credited or paid on interest-bearing deposits (or those registered with a brokerage house as nominee) in certain local financial institutions. An alternative tax of 17 per cent applies to non-exempt interest credited or paid by an individual retirement account.

An alternative tax of 10 per cent is imposed on non-exempt interest on obligations issued by Puerto Rican corporations or partnerships, or by foreign corporations or partnerships whose ECI (which includes Puerto Rican sourced income) 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 alternative tax also applies to non-exempt interest on certain residential Puerto Rican mortgages.

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

Non-resident US citizens are taxed on their Puerto Rican sourced income at the same rates as residents. However, certain items of Puerto Rican sourced income are subject to a 20 per cent withholding tax. On sales of Puerto Rican real property or stock, the withholding rate is 10 per cent.

Non-resident non-US citizens not engaged in business are taxable at a flat 29 per cent tax on Puerto Rican sourced fixed or determinable annual or periodic income and on net Puerto Rican sourced capital gains. The withholding at source at 29 per cent applies to everyone with such income, except that in the case of sales of Puerto Rican real property or shares of stock by a non-resident non-US citizen, the buyer withholds 25 per cent of the 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 of 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 as pass-through or disregarded entities. Partnerships are not subject to Puerto Rico income taxes. Rather, the partners of a partnership that is engaged in trade or business in Puerto Rico are subject to Puerto Rico income taxes on their distributive share in the partnership's income or gains. Such partners are considered to be engaged in trade or business in Puerto Rico with respect to their distributive participation in the income, gains, losses, deductions and credits of the partnership. Corporations are subject to a tax rate of 20 per cent on net income. For foreign corporations, the tax applies to net ECI (which includes Puerto Rican sourced income). Also, should the corporation net income exceed US\$750,000, it will be subject to additional income taxes on its net income exceeding US\$750,000 at the following rates:

Income subject to additional taxes	Additional tax rate
Maximum of US\$1,750,000	5%
Over US\$1,750,000	US\$87,500 plus 10% of the excess over US\$1,750,000

Unless otherwise exempt, all corporations are also subject to an alternative minimum tax (AMT) equal to the higher of 20 per cent of alternative minimum taxable income (AMTI) or 1 per cent of the value of purchases of personal property acquired from a related person. 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 that has the effect of accelerating recognition of income.

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

Foreign corporations engaged in trade or 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 Rican sources or from income effectively connected to the Puerto Rican trade or business 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 of the company's Puerto Rican branch that are not reinvested in Puerto Rico (the dividend-equivalent amount). Foreign tax credits against Puerto Rican tax are allowed for foreign taxes paid on non-Puerto Rican sourced ECI. Deductions and credits attributable to Puerto Rican income are allowed only upon filing Puerto Rican income tax return

reflecting the Puerto Rican income. Credit is allowed for taxes withheld at source.

Foreign corporations not engaged in trade or business in Puerto Rico are generally taxed on fixed or determinable annual or periodical gross income at 29 per cent to the extent amounts so received are considered to be from sources within Puerto Rico. Exceptions are dividend distributions that are taxed at 10 per cent. Certain royalties for use of industrial intangibles are also taxed at 2 per cent or 12 per cent. Gains derived from sources within Puerto Rico from sales or exchanges of capital assets that exceed losses allocated to sources within Puerto Rico from such sales or exchanges are subject to a 29 per cent tax. Interest on Puerto Rican bank deposits of up to US\$2,000, real property mortgages constituted before 1 July 1995 and interest received from unrelated persons is exempt.

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 0.50 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 combine rate ranges from US\$5.80 to US\$8.83 per US\$100 of reported value of personal property and US\$7.80 to US\$10.83 per US\$100 of assessed value of real property for fiscal year 2011–2012. Effective for fiscal years 2009–2010, 2010–2011 and 2011–2012, the assessed value of real property was increased tenfold, but the tax rate was decreased tenfold, so that the net tax remains the same prior to the increase in assessed values of real property. 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

Licences are required for the sale of cigarettes, vehicles and parts, gasoline, 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.

Coupled with the municipal sales and use tax of 1.5 per cent described above, the aggregate sales and use tax would be 7 per cent.

Excise tax

Special excise taxes apply upon the introduction, sale, consumption, use, transfer or acquisition of cement, sugar, 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?

Depending on the size of the local operations of the franchise, the franchisor may or may not have a local office or personnel stationed in Puerto Rico. The duties of such personnel typically relate to ensuring compliance with the franchise agreement and that the franchisor's trademarks, goodwill and reputation are enhanced and not adversely affected by the franchisee's operations.

If a local office is maintained or personnel are stationed in Puerto Rico, the franchisor – as an employer – will need to comply with all United States federal as well as all Puerto Rican labour and employment laws, as well as related payroll and Puerto Rican income tax withholding laws.

If the franchisor does not retain personnel in Puerto Rico to perform services on its behalf, in order to shield itself from employment-related claims by the franchisee's employees or being deemed to be the 'employer' of such employees, it needs to ensure the relation between the franchisor and the franchisee complies with the necessary separateness of an 'independent contractor' relation within the context of a franchise relation.

Although the employees of a well established or economically sound franchisee do not frequently present labour or employment claims against the franchisor, occasionally such claims are presented. To reduce the risk of such claims, the franchisor should do the following:

- ensure the franchise agreement disclaims any employment or agency relationship between franchisor and franchisee and that it specifies that hiring, firing, evaluation and discipline decisions relating to the franchisee's employees are the exclusive responsibility of the franchisee;
- require the franchisee to use its own corporate name and not the brand or franchise name in all employment related documents (employment policies, employee manuals, applications, disciplinary documents, identification cards, etc);
- require the franchisee maintain policies and procedures that comply with all applicable labor and employment laws, but the franchisor should not require adoption of its 'policies and procedures', nor should it provide such documents nor training related to same. Although the franchisor may monitor 'overall compliance' and provide recommendations, it should not become involved in day-to-day application of the policies;
- the franchisor should avoid frequent and close supervision of the work of franchisee employees on a regular basis.
- require the franchisee to identify itself, in all interactions with the public (such as phone calls and customer contacts) by its own name rather than the franchisor's name; and
- since Puerto Rico's unemployment and non-occupational insurance programmes use a more stringent 'ABC' test that has been invoked to hold a franchisor liable for a franchisee's failure to pay its required contributions to such programs, the franchisor may wish to consider closer compliance monitoring limited to such payments. See *Tastee Freez de Puerto Rico, Inc v Puerto Rico Department of Labour* 111 DPR 809 (1981).

- 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 or service mark (mark) is the actual use of the mark. Registration of a mark is not legally required but can provide distinct advantages and is highly recommended. Registration of a mark is prima facie evidence of ownership. Infringers are subject to various remedies, including 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. However, there is still some uncertainty about the extent of protection in situations where infringement is strictly intra-state. Local registration offers various procedural advantages in the protection of a trademark so that both US and local registration are recommended.

Registration of a mark in Puerto Rico is accomplished by filing an application setting forth the mark and the goods or services with which it is used 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. Applications may be filed based on existing use, in which case a specimen showing the mark as used with the claimed goods or services must be included. Applications may also be filed claiming an intent to use in commerce and, in this case, a use declaration setting forth the date of first use as well as a specimen showing how the mark is being used in commerce must be submitted within five years after filing the application. 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 declaration of continuing use accompanied by a specimen showing the use before the term expires. During the fifth year after the application filing date, a similar declaration of continuing use must be filed 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 that 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 geographical names or terms that are misleading or misrepresentative;
- (viii) any mark that is identical to another registered or known mark used for the same type of product or service;
- (ix) any mark so similar to another that its use will cause confusion or deception in the public's mind;
- (x) 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; or
- (xi) any mark that is identical or similar to a famous mark that is known by the relevant market sector in Puerto Rico, even though the mark is not used in Puerto Rico.

As an exception to points (iv) 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. Also, marks that contain both registrable and non-registrable materials may sometimes be registered if an exclusive claim to the problematic language is disclaimed.

Puerto Rico also recognises causes of action for dilution of marks by 'blurring' and by 'tarnishment'. Such causes apply to famous marks that are injured by certain actions. A mark may be diluted by 'blurring' when it is used in connection with goods or services other than those used by the original owner in such a way that people are confused as to the source of either the new or old goods or services. A mark is diluted by 'tarnishment' when the non-owner uses it in a way that damages the original through association with offensive or materials or goods or services of inferior quality.

Franchisors generally register relevant marks with both the United States Patent and Trademark Office and the Puerto Rico

Trademark Registry. These marks are then licensed to franchisees, either in the franchise agreement or in separate licence agreements. Under Puerto Rico's Law of Marks enacted in 2009, licensing of marks may be recorded with the Puerto Rico Trademark Registry, but this option has not been widely used and is not favoured by franchisors.

Puerto Rico's new Trade Secret Law, Act No. 80 of 3 June 2011, (the Trade Secrets Act) provides express protection for know-how. The Trade Secrets Act covers all information that is not generally known or accessible and provides its owner with an economic value or advantage, or from which another person might obtain economic value from disclosure. For protection under the Trade Secrets Act an owner must take appropriate measures to maintain the confidentiality of its information. The Trade Secrets Act does not provide an exhaustive list of measures that must be taken, but notes that the steps must be reasonable and provides examples such as:

- restricting the number of persons authorised to access certain information;
- requiring employees to sign a non-disclosure agreement;
- formally classifying information as confidential; and
- implementing technological restrictions on the transmission or use of information.

The Trade Secrets Act creates new causes of action against any person that:

- acquires from another person a trade secret that was acquired by improper means; or
- discloses a trade secret without the consent of the secret's owner, if the disclosing party knew or should have known the trade secret was obtained illicitly.

The Trade Secrets Act also attempts to maintain the secrecy of proprietary information by directing courts to take appropriate steps to guarantee the integrity and secrecy of a trade secret during any court proceeding, even those which are not specifically brought under the Trade Secrets Act. The main remedies available under the Trade Secrets Act are damages and injunctive relief and, in appropriate situations, awards of attorneys' fees or royalty payments. Franchisors should certainly consider the best way to use the Trade Secrets Act to protect valuable proprietary information, but the law has not been in operation long enough to evaluate the specific effects on franchise operations.

In addition to the Trade Secrets Act, the general Tort and Property Law of Puerto Rico as well as the unfair competition statutes and regulations may be used to protect trade secrets. Furthermore, rule 513 of the Puerto Rico Rules of Evidence declares trade secrets to be privileged information and 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 of Puerto Rico, the Mortgage and Registry of the Property Act of Puerto Rico and, when applicable, the Notarial Act of Puerto Rico. There are basically no unexpected aspects of the real estate market and real estate laws applicable to franchisors, when compared to other US jurisdictions, with the notable exceptions described below regarding the consequences of not recording real estate interests in the Registry of the Property.

The most relevant aspect of Puerto Rican real estate law is the civil law concept that in order to be protected with regards to third parties, the lessee needs to have its real estate interest recorded in the Registry of the Property; otherwise, the lessee would only have a contractual cause of action against the lessor should the leased property be sold to a third party.

In order to have access to the Registry of the Property, the real estate interest needs to be incorporated in a public deed executed before a notary public in Puerto Rico (or if executed outside Puerto Rico, it can be incorporated in a private document, notarised and then protocolised by a notary public in Puerto Rico). Furthermore, the authority of the appearing parties in the deed must be evidenced to the notary public by means of an authentic document that also needs to be notarised (that is, if executed outside Puerto Rico, it needs to be notarised in the jurisdiction in which it is executed and comply with all the required formalities). In the case of a partnership, the partnership agreement must also be in deed form and be included as a complementary document of the deed. The fees for the execution of the public deed and its recording in the Registry of Property are approximately US\$5.50 per thousand dollars of valuation, allocated as follows: US\$1.50 per thousand of valuation for Internal Revenue Stamps and US\$4 per thousand of valuation for the recording voucher. The valuation of a lease, however, is limited to rent that is going to be paid during the term of the lease or the first 12 years, whichever is less and without consideration of any extensions to the original term of the lease. Furthermore, the recording of the lease requires a filing fee of US\$10.50; allocated as follows: a US\$10 filing voucher plus US\$0.50 in internal revenue stamps required by the Puerto Rico Political Code. In addition, a mandatory fee must be paid to the notary before whom the deed is executed. The law provides for a mandatory fee of half per cent of the value of the transaction on the first US\$5 million. For any amount in excess of US\$5 million, the parties and the notary can agree on the notary fee (namely, only for the excess amount). Also, for leases with a term of less than six years, the owner of the leased property needs to consent to the recording of the lease at the Registry of Property. In leases for a term of six years or more (including leases for a term of less than six years, in which the lessee has the right, at its sole discretion, to extend the same for a period that would make the lease term, as extended, for a period longer than six years) that are in deed form, the lessee can request the recording of the deed at the Registry of Property without having the express consent of the owner of the property. If it is not in public deed, the lessee can demand that the lessor convert the lease into a public deed and then proceed to record the same.

The cancellation of a recorded lease also incurs several costs depending on the date of cancellation. If the lease is going to be cancelled because it expired pursuant to its own term, then the cancellation fee is a nominal amount of US\$20.50; allocated as follows: a US\$10 recording voucher plus a filing fee of US\$10.50 (allocated as follows: a US\$10 filing voucher and US\$0.50 in internal revenue stamps). If the cancellation of the lease is requested before the expiration of the same, then the cancellation costs are to be calculated in the same manner as the recording costs (US\$5.50 per thousand of the valuation as explained above).

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

Puerto Rico does not have any laws specifically regulating franchises, thus the term 'franchise' is not defined under Puerto Rican law.

Act No. 75 of 24 June 1964, as amended, also known as the Puerto Rico Dealers Act (Law 75) was enacted principally to govern dealerships. When defining a 'dealer's contract', Law 75 refers to the concept of franchise. Law 75 defines a 'dealer's contract' as a 'relationship established between a dealer and a principal or grantor whereby and irrespectively of the manner in which the parties may call, characterise or execute such a 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'.

The concept of 'principal' is defined under Law 75, as the 'person who executes a dealer's contract with a dealer'. 'Dealer', in turn, is defined as the 'person actually interested in a dealer's contract because of the person being effectively in charge in Puerto Rico the distribution, agency, concession or representation of a given merchandise or service'.

Franchisors and franchisees have been considered principals and dealers, respectively, for purposes of Law 75.

In addition, see the discussion in 'Update and trends'.

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

The offer and sale of franchises is not expressly regulated under Puerto Rican laws or by any government agency. Puerto Rico, however, is subject to US laws and regulations, including the Federal Trade Commission Franchising Regulations.

In addition, see the discussion in 'Update and trends'.

11 Describe the relevant requirements of these laws and agencies.

See question 10.

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

Law 75 protects 'dealers'. As stated in the answer to question 9, under Law 75, a dealer is defined as any person who is effectively in charge of the Puerto Rico distribution, agency, concession or representation of a given merchandise or service. To the extent the person is effectively in charge, that person will be considered a dealer, regardless of whether it is an exclusive or non-exclusive relationship or if the agreement is in writing. There has been much litigation over who is or is not a dealer protected by Law 75. The courts have adopted the following characteristics to assist them in determining who is considered a 'dealer' under Law 75:

- promotion of the product;
- closing of contracts;
- keeping an inventory;
- fixing prices;
- negotiating terms of sales;
- delivery and billing responsibilities;
- authority to extend credit;
- advertising campaigns;
- assumption of risk;
- purchasing the product;
- maintaining facilities; and
- offering product-related services to clients.

The courts have continually applied the above criteria to determine who is considered a dealer under Law 75. The courts have also repeatedly stated that these criteria are not exhaustive and no one criterion is determinant nor is any particular criteria entitled to more weight than others. The absence of one or two or a few of the activities of a dealer is not sufficient grounds to sustain that the person is not a dealer. The courts generally take into consideration the totality of the activities of the person.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

See question 10.

14 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 question 10.

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

See question 10.

16 What information must the disclosure document contain?

See question 10.

17 Is there any obligation for continuing disclosure?

See question 10.

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

See question 10.

19 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 question 10.

20 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 question 10.

21 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?

Franchise agreements will be subject to the general principles of contract formation found in the Civil Code of Puerto Rico.

Also, please note that typically franchise agreements are contracts of adhesion. In an effort to correct the presumed economic imbalance between the parties to an adhesion contract, Puerto Rican case law has established that the agreement shall be analysed in the manner most favourable to the weaker party, in all probability, the franchisor.

In addition, see the discussion in 'Update and trends'.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub franchisee regarding predecessors, litigation, trademarks, fees etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

See question 10.

23 What 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?

In Puerto Rico, a franchisor engaging in fraudulent or deceptive practices in connection with the offer and sale of franchises may incur contract or tort liability (or both). The franchisor may also be subject to penalties and liabilities under US law. Depending on the practice, the parties and the franchise agreement, an action may be brought before local or US courts, or arbitration.

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

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

Law 75 protects dealers (including franchisees) in Puerto Rico by providing that, notwithstanding the explicit provisions of any dealer contract, a principal cannot terminate, refuse to renew or impair an established dealer relationship unless there is 'just cause'. As previously stated, the agreement need not be in writing.

Law 75 overrides contractual provisions. Thus, the provisions of any franchise agreement must be read in the light of Law 75. In addition, Law 75 rights cannot be waived. Contractual provisions contrary to Law 75 will be unenforceable under the statute.

In addition, see question 10 as well as the discussion in 'Update and trends'.

25 Do other laws affect the franchise relationship?

The franchise relationship will be subject to Puerto Rican and US antitrust laws. Puerto Rican antitrust laws are modelled on and closely resemble those of the US.

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

No other government or trade association policies affect the franchise relationship.

27 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 Law 75, a franchisor may not terminate, refuse to renew or impair an established franchise relationship, unless there is 'just cause'. The statute defines 'just cause' as the 'non performance of any of the essential obligations of the dealer's contract, on the part of the dealer, or any action 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'. There has been a significant amount of Law 75 litigation. However, the case law does not shed much light on what constitutes 'just cause'. Nevertheless, it is clear that a mere technical breach will not constitute 'just cause' and the breach must be substantial and relate to a material aspect of the relationship.

If there is no 'just cause', the franchisor will be liable for the wrongful termination, refusal to renew or impairment of the agreement. The law provides for a statutory penalty of five times average annual profits, an amount for goodwill and reimbursement for expenditures that cannot reasonably be utilised in a different endeavour.

The statute also allows an aggrieved party to seek a temporary injunction forcing the principal to continue the unwanted relationship until the issue of damages is resolved.

In addition see the discussion in 'Update and trends'.

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

Law 75 does not address the termination or non-renewal of a franchise relationship by the franchisee. The Civil Code of Puerto Rico, on the other hand, allows contracting parties to make the agreements and establish the clauses and conditions that they deem advisable, provided they are not in contravention of law, morals, or public policy. Thus, to the extent they are not contrary to law, morals, or public policy, the franchise agreement may provide for the circumstances in which a franchisee may terminate a franchise relationship. Also, under general contract principles, the right to rescind the obligations is considered as implied in mutual ones, if one of the obligated persons does not comply with what is incumbent upon him or her. Thus, to the extent the franchisor fails to fulfil his or her essential obligations under the franchise agreement, the franchisee may opt to terminate the franchise relationship.

In addition, see the discussion in 'Update and trends'.

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

See question 27.

30 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 for just cause. Law 75 provides that any contractual provision to prevent the Distributor's ability to freely sell, transfer or encumber any interest in the distribution business is unenforceable. Specifically, Law 75 provides that the:

[...] violation or non performance by a dealer of any provision included in the dealer's contract to prevent or restrict changes in the capital structure of the dealer's business, or changes in the managerial control of said business, or the manner or form of financing the operation, or 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.

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

Other than the previously discussed tax provisions (see question 5), there are no laws or regulations affecting the nature, amount or payment of fees by the franchisee to the franchisor.

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

Puerto Rican laws and regulations do not set maximum charges and rates of interests that may be charged on credit granted for commercial purposes.

Please note that, in general, Puerto Rico law prohibits anatocism (namely, compounding of interest or charging of interest on unpaid interest). There are two exceptions. If a judicial demand is made for unpaid interest, then the law provides for the charging of legal interest (6 per cent) on the unpaid interest after judicial demand is made. The law also permits the parties to agree to capitalise unpaid interest as principal and, thereafter, to charge interest on such a capitalised amount. However, prior agreements to capitalise unpaid interest are not valid; the agreement to capitalise unpaid interest can only be made after the interest has accrued and remains unpaid.

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

There are no Puerto Rican laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency.

34 Are confidentiality covenants in franchise agreements enforceable?

To the extent the confidentiality covenant included in a franchise agreement is not contrary to law, morals or public policy, it will be enforceable. The inclusion of confidentiality covenants in franchise agreements is highly advisable.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Puerto Rican law requires that all obligations be performed in good faith. In general terms, this implies that the parties to the franchise relationship act in a fair and cooperative manner.

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

No. Puerto Rican law treats franchisees as consumers for the purposes of consumer protection or other legislation.

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

Spanish and English are the official languages of Puerto Rico. As long as the contracting parties understand the language used in the franchise agreement, there is no requirement that franchise agreements be in Spanish or English.

38 What restrictions are there on provisions in franchise contracts?

Law 75 overrides contractual provisions. Thus, the provisions of any franchise agreement must be read in light of Law 75. Contractual provisions contrary to Law 75 will be unenforceable under the statute.

Law 75 establishes several restrictions with which the provisions included in a franchise agreement must abide.

A franchisor may not terminate or refuse to renew the established franchise relationship, unless there is 'just cause'. Law 75 provides that any contractual provision to prevent the franchisee's ability to freely sell, transfer or encumber any interest in the franchise business is unenforceable. Similarly, quotas or goals established in the franchise agreement must adjust to the realities of the Puerto Rican market or may be held unenforceable.

Law 75 also provides that the choice of non-Puerto Rican law to govern the agreement is unenforceable under Law 75.

Further, any stipulation obligating a dealer to adjust, arbitrate or litigate any controversy arising from the dealer's contract outside

Puerto Rico, or under foreign law or rule of law, shall be likewise considered as violating the public policy set forth by Law 75. The US Federal Arbitration Act pre-empts Law 75's restraint on arbitration outside of Puerto Rico. However, Law 75 was amended to require that a court with jurisdiction in Puerto Rico determines that such arbitration provision was subscribed freely and voluntarily by both parties. Further, the amendment established a rebuttable presumption that arbitration clauses are adhesion clauses to be interpreted and made effective as such.

Finally, Law 75 rights cannot be waived.

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

See question 23.

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

The structure of the Puerto Rican court system is comparable to that of any of the states of the US. The Puerto Rican judicial branch consists of a Supreme Court, a Court of Appeals and the courts of first instance. Ultimate appeal is made to the Supreme Court of Puerto Rico and, in certain cases, to the US Supreme Court.

Puerto Rico also participates in the US district court system. The decisions of the US District Court for the District of Puerto Rico are reviewed by the US Court of Appeals for the First Circuit.

Mediation and arbitration are also viable and recognised mechanisms of dispute resolution in Puerto Rico.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The primary advantage of arbitration for a foreign franchisor is the ability to require the franchisee to hold the arbitration proceedings in the country of the foreign franchisor's residence. This gives the franchisor a 'home court' advantage. Furthermore, if the franchise agreement provides for the choice of other than Puerto Rican law to govern the franchise agreement, there is the possibility that the arbitrator may respect such a choice of law, notwithstanding the provision of Law 75 that the choice of other than Puerto Rican law is not enforceable in contracts governed by Law 75.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Under Puerto Rican law, foreign and domestic franchisors are subject to the same treatment.

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