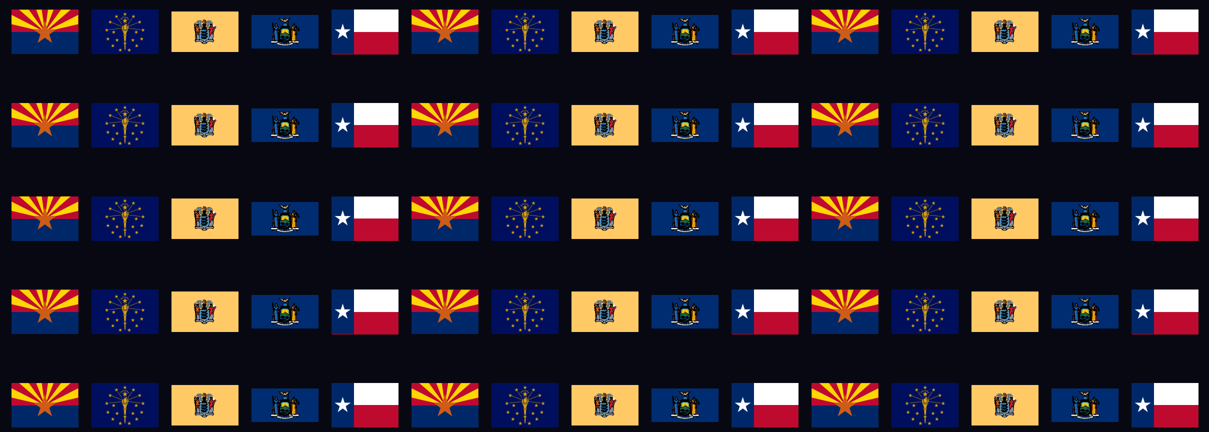
FRANCHISE USA

USA - New York



Franchise USA

Quick reference guide enabling side-by-side comparison of local insights, including into market climate and general legal framework; the franchisor/franchisee relationship; IP, data protection and cybersecurity; competition law; employment and labour; real estate; taxation; dispute resolution (including alternative dispute resolution); and recent trends.

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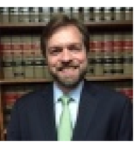

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MARKET CLIMATE AND GENERAL LEGAL FRAMEWORK

Market climate

What is the extent of franchise business in your state, including any franchise-heavy sectors?

Prior to the outbreak of the coronavirus (COVID-19) pandemic, the outlook for franchise business in the United States in 2020 was positive. The International Franchise Association (IFA), a leading franchise organization, indicated on its website in February 2020, that the franchising industry was expected to “continue riding the economic boom in 2020, despite growing uncertainty around the economy.” In February 2020, the IFA released its Franchise Business Economic Outlook Report detailing the franchise industry’s projected economic forecast for 2020. Among the many facts highlighted in the Report is that overall, franchise business development will continue to increase in the south and west due to growing populations, state-level economic policies and favorable business tax climates. The Report also indicated that the number of franchised businesses in the U.S. forecasted growth of 1.5% in 2020, to a total of 785,316 establishments.

According to the above referenced Report, New York was among the top 10 states with the highest franchise establishments. However, New York was not projected to be among the top 10 states in franchise growth in 2020 in terms of new franchise outlets and new jobs created. Rather, New York was projected to have a slight negative growth rate (-0.4%) in terms of franchise establishments, down to 30,285 from 30,395 in 2019. In terms of franchise employment, New York State was projected to have a small increase (0.8%) up to 334,674 from 331,856 in 2019. Regarding franchise output, New York State projected growth of 2.9% up to $41,196 (in millions) from $40,018 (in millions) in 2019. However, that positive outlook and the forecasts for 2020 did not materialize either in the United States as a whole, or in New York, because of the COVID-19 crisis.

The IFA’s Economic Outlook Report for Franchising 2021 indicated that, assuming the coronavirus was “under control” by year-end 2021 (which did not occur), FRANdata predicted that franchising will have recovered to nearly 2019 levels in most metrics, such as business growth, employment, economic outlook and contribution to GDP. The Report also indicated that FRANdata forecast a net gain of 26,000 franchised small businesses in 2021 bringing the total number of franchises in the U.S. to over 780,000, which is approximately 6,500 more units than pre-COVID levels in 2019. Further, the Report predicted that by year-end 2021, franchises will employ approximately 8.3 million people, adding nearly 800,000 jobs, about 10%. It was anticipated that most of these new jobs will be in retail, food or service industries and will mainly consist of lower-skilled workers, a group that has been hit disproportionately hard by the COVID-19 pandemic.

The IFA’s Report for 2021 also indicated that New York State’s economy fared the worst amid the pandemic. A net total of 70,000 people left the metropolitan region in 2020, resulting in roughly $34 billion in lost income. According to the 2021 Report, FRANdata estimated that New York State was the state with the highest number of small businesses that were heavily impacted by the pandemic. New York also had an unemployment rate that was higher than the national average as of November 2020.

As of the time of the writing of last year’s update (August 2021), the United States was still in the grip of the COVID-19 crisis. The numbers of infections and hospitalizations related to the coronavirus were once again increasing across the country, especially in the southeast. In the summer of 2020, most states either “paused,” “scaled back” or reversed their “business re-opening” initiatives. While most businesses fully reopened in the first half of 2021, the emergence of the delta variant of the COVID-19 virus in the summer of 2021 caused many cities and communities to reinstitute mask mandates for indoor activities. An ever-increasing number of local governments and private employers began instituting vaccination requirements for their employees, and some local governments, including New York City, began instituting vaccine mandates for certain indoor activities including entertainment, recreation, dining and fitness settings. Then, New York City Mayor Bill DeBlasio, announced that New York City public school and personnel were required to be vaccinated and have at least their first dose by September 27, 2021 and everyone in New York City public

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schools was required to wear masks at the beginning of the Fall 2021 school year.

Back in April and May 2020, New York State was known as the “epicenter” of the COVID-19 crises. However, later in the year, New York was successful at “flattening the curve.” In 2021, New York had the fourth highest total number of COVID-19 infections in the United States, after California, Texas and Florida. As of the summer of 2021, New York has reported more than 2.25 million cases and has suffered more than 55,000 deaths since the pandemic began. In June 2021, New York City saw the positivity rate, hospitalizations and deaths decrease to their lowest points since the lockdowns occurred in March 2020. However, since June 2021 the delta variant has emerged, the positivity rate has increased and on August 14, 2021, New York City marked its millionth COVID-19 case. While deaths remain low, the number of hospitalizations has increased in July and August 2021.

The IFA’s 2022 Franchising Economic Outlook Report states that franchising had an exceptional year in 2021 and that 2022 is expected to have another strong recovery. Due to a strengthening labor market and steady consumer spending, franchising is expected to continue to expand. However, the pace of growth in 2022 is expected to moderate, due to the current headwinds in the economy. According to FRANdata, more than 75% of franchisees received federal pandemic relief funding through the PPP and other programs, and that this financial relief resulted in the average franchised small business receiving approximately $80,000 in loans saving more than 20,000 franchised small businesses from permanently closing and helping to preserve almost 500,000 jobs. While certain states are expected to see a faster “return to normalcy” as they have adopted relatively well based upon a more conducive business climate or favorable migration trends and changes regarding consumer preferences, some states including New York will take a longer time to achieve full recovery, as they were “hardest hit” by the pandemic and have experienced a loss of population. The explosion of remote and hybrid work has led to people from states such as New York relocating to states with affordable housing and low cost of living, searching for a better quality of life.

As of this writing (August 2022), New York State ranks fourth in the number of COVID-19 cases, behind California, Texas and Florida, with approximately 5.91 million cases. Despite high COVID-19 vaccination rates, New York State has recorded over 70,000 deaths since the pandemic began. New York City alone has reported 2.78 million COVID-19 cases and has reported over 41,000 deaths,

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Legislation

Are there any specific franchise laws in your state? What other legal regimes apply?

Franchisors must comply with both New York State and federal law requirements with respect to the offer and sale of franchises. Federal law requirements impose pre-sale disclosure obligations on franchisors, whereas New York’s franchise statute imposes both pre-sale disclosure obligations as well as a registration requirement. Neither federal law nor New York franchise law seek to regulate the “franchisor-franchisee relationship” after the franchise purchase has been consummated.

The U.S. Federal Trade Commission (FTC) is the federal agency that governs the manner in which franchises are offered for sale throughout the United States. The FTC promulgated its initial “Franchise Rule” (16 C.F.R. Part 436) in 1978. The Franchise Rule was significantly amended in 2007 and is commonly referred to as the FTC Amended Franchise Rule (the “Franchise Rule”). The Franchise Rule imposes only a pre-sale disclosure obligation requiring franchisors to provide prospective franchisees (and multi-unit developers) with important information they need to make an informed decision about whether to invest in the franchise system. Required disclosure topics include: the franchise’s litigation history, past and current franchisees and their contact information, any exclusive territory that comes with the franchise, assistance the franchisor provides franchisees, and the cost of purchasing and starting up a franchise. Under the Franchise Rule, franchisors provide prospective franchisees with a comprehensive disclosure

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document called the Franchise Disclosure Document (FDD) at least 14 days prior to signing any binding agreement regarding the franchise or paying any money to the franchisor. The FDD contains 23 wide-ranging categories (referred to as “Items”) of disclosure (including the FDD Receipt that is signed and dated by the prospective franchisee and returned to the franchisor), together with copies of all of the written agreements (including among others, the Franchise Agreement) that the prospective franchisee will be required to sign when it purchases the franchise. If the prospective franchisee wants to purchase the rights to open more than one franchise location, then it (or its affiliate) will be required to also enter into a Multi-Unit Development Agreement, which is included in the franchisor’s FDD. The Franchise Rule does not require franchisors to register their FDD with any federal administrative or governmental agency.

New York State’s franchise statute, NY Gen Bus L § 680, et al. (NYFSA) is commonly described as a disclosure/registration law. Like the FTC Franchise Rule, the NYFSA imposes pre-sale disclosure requirements on franchisors (e.g., providing prospective franchisees with the FDD). The NYFSA requires that the FDD be delivered to the prospective franchisee at the earlier of: (i) the “first personal meeting” with the franchisor (or its agent, any representative or employee); or (ii) at least “10 business days” prior to either signing of any binding franchise or other agreement or receiving any “consideration” in connection with the sale or proposed sale of a franchise. This provision is meaningful because, unlike the FTC Franchise Rule, which requires the delivery of the FDD to the prospective franchisee at least “14 days” before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or an affiliate in connection with the proposed franchise sale, under the NYFSA, if the prospective franchisee has a personal meeting with the franchisor (which usually occurs early on in the franchise sales process), the franchisor’s requirement to disclose the prospective franchisee with the FDD is immediately triggered and the FDD must be delivered at the in-person meeting.

However, under the NYFSA, franchisors are also required to register their franchises before they are permitted to offer or sell franchises. When a “new” franchisor files its initial registration application with the New York Attorney General’s Office (NY AG), together with its initial FDD, the franchisor is permitted to offer or sell franchises after it receives the NY AG’s written approval of its application and FDD. For each subsequent year that the franchisor seeks to offer or sell franchises, the franchisor is required to file a renewal registration application and to file its updated FDD (including the franchisor’s updated financial statements) with the NY AG within 120 days after the end of the franchisor’s fiscal (or calendar) year, whichever it uses for tax purposes.

Under Section 687 of the NYFSA, “fraudulent and unlawful practices” in the context of required disclosure are also made illegal. The NY AG has also promulgated New York State Franchise Regulations (Title 13, NY Codes and Regulations, Part 200) (NY Regulations) that supplement the disclosure and registration requirements set forth in the NYFSA.

The scope of the NYFSA’s applicability is extremely broad. While the statute covers the “offer or sale of franchises in New York” this is defined very broadly under the law. For example, the NYFSA is applicable both where franchisors offer or sell franchises from New York to anywhere in the world (e.g., offers being made by New York based franchisors), or where “out-of-state” franchisors offer or sell franchises either to residents of New York or where the franchised business will operate in New York. Further, the NYFSA’s definition of “franchise” is also very broad. This may cause certain businesses to unintentionally establish a “franchise relationship” with others that may subject the unwitting “franchisor” (and its principals) to the NYFSA’s disclosure and registration requirements and therefore, to potential civil liability and even criminal exposure.

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Regulators

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Which regulatory authorities are tasked with enforcing the legislation applicable to franchises and what is the extent of their authority?

All franchisors are required to comply with the FTC Franchise Rule in connection with the offer and sale of franchises anywhere in the United States. Violations of the Franchise Rule are punishable as violations under the Federal Trade Commission Act. The FTC has the authority to sue franchisors in federal court and to impose civil penalties of not more than $11,000 per compliance violation. In addition, the FTC may seek to obtain preliminary and permanent injunctive relief (including the full range of equitable remedies) in federal court. Such actions often result in monetary redress made to injured consumers (e.g., franchisees). However, franchisees have no private right of action under the Franchise Rule, and they are unable to sue franchisors in a civil action whereby they would be seeking damages and/or injunctive relief.

Unlike with the FTC Franchise Rule, franchisees have a private right of action with respect to violations of the NYFSA. Pursuant to Section 691 of the NYFSA, a franchisor who offers or sells a franchise in violation of the NYFSA is liable to the franchisee for damages and, if the violation is both wilful and material, for rescission, together with interest at 6% per year from the franchisee's date of purchase, as well as reasonable attorneys' fees and court costs. The NYFSA also provides that joint and several liability may be imposed on a person who directly or indirectly controls the franchisor, such as a principal executive officer or director of the franchisor, and an employee of the franchisor, who "materially aids" in the violation. The NYFSA provides for a three-year statute of limitations. Accordingly, franchisees must bring civil claims against franchisors (and or their principals, officers, employees, etc., who "materially aided" the franchisor's violation of the NYFSA) within three years from the date the franchise agreement is entered into, or their claims will be time barred. Under Section 690 of the NYFSA, any person who knowingly violates the NYFSA shall be guilty of a class A misdemeanor, which is punishable by a fine of not more than $1,000 or imprisonment for not more than one year, or both.

Under Section 689 of the NYFSA, the New York Attorney General's Office (NY AG) may bring an action on behalf of the people of the State of New York to enjoin any person from participating in unlawful and fraudulent practices in the context of required disclosure, that are proscribed by Section 687 of the NYFSA. Further, pursuant to Section 692 of the NYFSA, the NY AG is authorized to prosecute any person charged with a criminal offense in violation of the NYFSA

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Legal definition of "franchise"

Is there a legal definition of what constitutes a "franchise" in your state?

Yes, Section 681(3) of the NYFSA defines a "franchise" as follows:

> *'"Franchise" means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:'*
>
> *'(a) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor, and the franchisee is required to pay, directly or indirectly, a franchise fee,'*
>
> *'or'*
>
> *'(b) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial designating the franchisor or its affiliate, and the franchisee is required to pay, directly or indirectly, a franchise fee.'*

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> *'A franchise under this article shall not include any agreement, contract, or franchise subject to the provisions of article eleven-B of this chapter or section one hundred ninety-nine of this chapter, or any agreement or contract for the sale of motor fuel.'*

It should be noted that the NYFSA's definition of "franchise" is very broad. Whereas many states require both (a) above (the "marketing plan or system" requirement) and (b) above (the "associated with the franchisor's trademark" requirement); together with a "franchise fee," the NYFSA definition only requires either (a) or (b) above, together with, in either case, a franchise fee. As a result, sometimes businesses that are intending to offer "licensing" or similar opportunities may actually fall within the NYFSA's broad legal definition of "franchise," and by so doing, may unwittingly expose themselves to significant civil liability and potential criminal exposure as well. It is recommended that knowledgeable franchise counsel be consulted so that he or she can review the components of the business relationship, contacts and communications between the parties (including "licensors" that are headquartered in New York) in order for such a business to avoid being deemed to be an "inadvertent franchisor."

Although the FTC Franchise Rule contains a different definition of "franchise," the above NYFSA definition is the controlling definition of "franchise" under New York law.

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Formal requirements

Are there any formal requirements for franchise sales activity in your state? Are any exemptions available?

Yes. New York's franchise statute (NYFSA) provides (with certain limited exemptions which are discussed below) for pre-sale disclosure obligations as well as a registration requirement as a pre-condition to franchise sales activity in New York (or emanating from New York).

Under the NYFSA, franchisors are generally required to register their franchises with the New York Attorney General's Office (NY AG) before they are permitted to offer or sell franchises (unless one or more statutory exemptions apply). A "new" franchisor files its initial registration application with the NY AG, together with its initial FDD. After the franchisor receives written approval of the application and FDD from the NY AG, the franchisor is permitted to offer or sell franchises. Each subsequent year that the franchisor offers or sells franchises, the franchisor is required to file with the NY AG, a renewal registration application together with its updated FDD, within 120 days after the end of the franchisor's fiscal year.

The NYFSA also imposes pre-sale disclosure requirements on franchisors (e.g., providing prospective franchisees with the FDD). The NYFSA requires that the FDD be delivered to the prospective franchisee at the earlier of: (i) the "first personal meeting" with the franchisor (or its agent, any representative or employee); or (ii) at least "10 business days" prior to the signing of any binding franchise or other agreement or receiving any "consideration" in connection with the sale or proposed sale of a franchise. This provision is meaningful because, unlike under the FTC Franchise Rule which requires the delivery of the FDD to the prospective franchisee at least "14 calendar days" before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or an affiliate in connection with the proposed franchise sale, under the NYFSA, if the prospective franchisee has a personal meeting with the franchisor (which usually occurs early on in the franchise sales process), the franchisor's requirement to disclose the prospective franchisee with the FDD is immediately triggered and the FDD must be delivered at the in-person meeting.

Under the NY Regulations promulgated by the NY AG, franchisors are not permitted to distribute, communicate or publish any advertisement or sales literature to prospective franchisees prior to filing copies of the advertisement or sales literature with the NY AG and obtaining its approval. Further, under the NY Regulations, "franchise sales agents"

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who "directly or indirectly engage in the offer or sale of any franchise on behalf of another" are required to register with the NY AG by filing a "Franchise Seller Disclosure Form."

As referenced above, in certain limited circumstances, the NYFSA provides exemptions from its registration requirements. Some of the primary exemptions include:

- the "large franchisor" exemption (i.e., where the franchisor has a net worth, according to its most recent audited financial statement, of at least $5 million dollars; or the franchisor has a net worth, according to its most recent audited financial statement, of at least $1 million dollars and is at least 80% owned by a corporation that has a net worth on a consolidated basis, according to its most recent financial statement, of no less than $5 million);
- the "isolated sale" (or "single sale") exemption (i.e., where the transaction involves an offer directed by the franchisor to no more than two persons, if the franchisor does not grant the franchisee the right to offer franchises to others);
- sale by existing franchisee;
- sale by franchisor to existing franchisee; and
- by order of the NY AG if it finds that granting an exemption from registration is not "inconsistent with the public interest or the protection of prospective franchisees."

Prior to October 2021, franchisee counsel could argue with some confidence that notwithstanding the fact that a franchisor has an exemption from the NYFSA's registration obligations, the franchisor is still obligated, in each such instance, to provide the prospective franchisee with proper disclosure (e.g., a current FDD). However, following an October 2021 decision by the Eastern District of New York, this position would appear to be in doubt. The court's decision in Ariz. Family Florists v. 1-800-Flowers.com , Inc ., 2021 U.S. Dist. LEXIS 206449; 2021 WL 4959426, found that where the franchise at issue was exempt from registration, and therefore, was not "subject to registration under this article," the franchisor did not have to provide the franchisee with an offering prospectus (e.g., an FDD) containing the disclosures required by the applicable disclosure sections of the NYFSA. Based upon the Ariz. Family Florists case (which relies on a 1992 Supreme Court of New York, Appellate Division, Second Department case, Dunkin' Donuts, Inc. v. HWT Assocs ., 181 A.D.2d 711; 581 N.Y.S.2d 363; 1992 N.Y. App. Div. LEXIS 3288), franchisee counsel should not be certain that their long held position that a franchisor still has to provide disclosure (e.g., the current FDD) to a prospective franchisee even if the franchisor at issue has an exemption from registration under the NYSFA, will be upheld under current New York law. How this position will stand up if it is analyzed in the future and appealed, remains (potentially) to be seen.

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Pre-contractual disclosure requirements

Do any special pre-contractual disclosure requirements apply?

Yes, the NYFSA requires that the FDD be delivered to the prospective franchisee at the earlier of: (i) the "first personal meeting" with the franchisor (or its agent, any representative or employee); or (ii) at least "10 business days" prior to the signing of any binding franchise or other agreement or receiving any "consideration" in connection with the sale or proposed sale of a franchise. This provision is meaningful because, unlike with the FTC Franchise Rule which requires the delivery of the FDD to the prospective franchisee at least "14 calendar days" before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or an affiliate in connection with the proposed franchise sale, under the NYFSA, if the prospective franchisee has a personal meeting with the franchisor (which usually occurs early on in the franchise sales process), the franchisor's requirement to disclose the prospective franchisee with the FDD is immediately triggered and the FDD must be delivered at the in-person meeting.

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Further, while both the NYFSA and the FTC Franchise Rule require franchisors to provide their financial statements as part of their FDD, the NYFSA's requirements, as set forth in the NY Regulations, are more stringent than the requirements under the FTC Franchise Rule which provide for a "phase-in" for new franchisors with respect to providing financial statements. For example, under the FTC Franchise Rule, a franchisor is permitted to include only an unaudited opening balance sheet in its initial FDD, whereas under the NYFSA, an audited opening balance sheet is required. For the second fiscal year that a franchisor is selling franchises, the FTC Franchise Rule requires only an audited balance sheet as of the end of the first partial or full fiscal year selling franchises, whereas under the NYFSA, the full range of audited financial statements are required as of the end of the first fiscal year including a balance sheet, statement of operations (profit and loss statement) statement of stockholders equity and statement of cash flows. Franchisors who are subject to the NYFSA must comply with the more stringent provisions of the NY Regulations rather than the less stringent FTC Franchise Rule requirements with respect to providing their financial statements in the FDD.

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Available company forms/business structures

Are there any state-specific considerations that franchisors should bear in mind when choosing a business model or company structure?

Franchisors should be aware that if they are headquartered in New York State, they will be required to register their franchise with the NY AG, and therefore, every offer or sale of a franchise they make within the United States (and even internationally) will be subject to the pre-sale disclosure provisions (including the "fraudulent and unlawful practices" proscriptions) as well as the franchisee protections provided for by the NYFSA. If a franchisor felt strongly, either that it did not want to have to register its franchise with the NY AG (e.g., if the franchisor was not looking to sell any franchises in New York State at the time) or more likely, that it did not want to subject itself to the NYFSA for every offer or sale of a franchise that it made within the United States (and even internationally), then the franchisor might consider having its principal place of business (as well as its office from which its franchise sales agents or sales brokers would be operating when offering franchises to prospective franchisees), located outside of the State of New York.

Franchisors should also be aware that if they form any limited liability companies in New York State as part of their "company structure" they will be required by law to publish the entity's formation in local newspapers. This would entail additional out-of-pocket publication related expenses and filing fees of several hundred dollars for each LLC that was formed in New York beyond the required filing fees payable to the Secretary of State relating to each entity's formation.

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THE FRANCHISOR/FRANCHISEE RELATIONSHIP

Due diligence

What due diligence should both parties undertake before entering into a franchising relationship?

The franchisor stands to gain substantial benefits from onboarding new franchisees. Not only does the franchisor expand the system, but it also achieves a financial benefit since franchisees are typically required pay an initial franchise fee, as well as ongoing royalties and other recurring fees (e.g., advertising fees) under the franchise agreement. Small, start-up franchisors may be so starved for the economic infusion or eager for growth that they may be inclined to make the mistake of accepting franchise candidates without properly vetting their qualifications. The franchisor should only offer franchises to prospects who have the financial wherewithal, vision and can-do attitude to succeed as franchisees in the franchise system. It is important, therefore, that the franchisor do its due diligence to

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ensure that prospective franchisees are sufficiently capitalized to finance the initial investment and can weather any operating losses that may accrue, until the business finds its footing. The franchisor should also gauge the prospective franchisee's general business acumen and know-how, and any industry-specific experience that might make the franchisee more likely to succeed. As part of its pre-contract review process, the franchisor should require that franchise candidates fill out a franchise application that asks for this type of information. The prudent franchisor may also obtain written consent from a prospective franchisee to run a background check and credit report.

On the other hand, it is critical that a franchisee prospect conduct its own due diligence before signing a franchise agreement and making the substantial financial investment that is often required to become a franchisee. First and foremost, the prospective franchisee must thoroughly review the FDD it receives from the franchisor. In that context, it is strongly advisable that the prospective franchisee retain an attorney who is well-versed in franchise law and who can help the franchisee understand all the nuances of the 23 items of disclosure in the FDD. It is also worthwhile for a prospective franchisee to hire an accountant to analyze any financial performance representations disclosed in Item 19 of the FDD as well as the audited financial statements of the franchisor that are disclosed in Item 21. The accountant can also assist a prospective franchisee in preparing a business plan, which is an essential tool for the franchise candidate to assess whether, upon making the purchase, it can make the franchised business profitable over time and that it can fund the possible losses that may be incurred. A prospective franchisee should contact as many, and as diverse a group of, franchisees in the system as possible (but not less than 13 to 15 if that many exist), in order to obtain their insiders' perspective regarding the pros and cons of the system. In New York, where a franchisor is required to register its FDD before selling franchises, a prospective franchisee should always confirm that the franchisor is, in fact, registered in the State of New York and approved to offer and sell franchises.

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Regulation of ongoing relationship

Do any state laws regulate the ongoing franchisor/franchisee relationship after they enter into the franchise agreement?

New York's franchise statute, the New York Franchise Sales Act (NYFSA), governs the disclosures that a franchisor may legally make to a prospective franchisee prior to their execution of a franchise agreement. However, the NYFSA does not regulate the ongoing relationship (by means of a so called "Relationship Law") between the franchisor and franchisee after they have signed a franchise agreement.

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Amendment of terms

What rules and restrictions govern the amendment of franchise agreement terms?

A franchise agreement that has a term of at least one year (as most do) must be memorialized in a writing and signed by the party to be charged in order to satisfy the statute of frauds. N.Y. Gen. Oblig. L. § 5-701(a)(1). Otherwise, the agreement is void as a matter of law.

Once a contract is formed, the parties can still modify its terms pursuant to a new agreement or in accordance with a course of conduct that develops between them. However, under New York law, a "no oral modifications" clause in an agreement is enforceable. N.Y. Gen. Oblig. L. § 15-301. So, as long as the franchisor includes a boilerplate "no oral modifications" clause in the franchise agreement (as it typically does), an oral agreement that purports to modify the terms or conditions of the contract is generally unenforceable. There are, however, certain exceptions under which an oral modification may still be enforceable and can overcome a "no oral modifications" clause. For example, if the

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franchisor, who has knowledge of the real facts, makes a false representation or conceals material facts, with the intention of with the reasonable expectation that such conduct will be relied upon by the franchisee, and the franchisee relies on the franchisor's conduct (e.g., enters into the franchise agreement) to its detriment (e.g., loses money), then the franchisor may be equitably estopped (under the doctrine of equitable estoppel) from invoking the benefit of the "no oral modification" clause contained in the franchise agreement. Similarly, if the franchisor makes a clear and unambiguous promise to the franchisee and the franchisee reasonably and foreseeably relies on the promise (enters into the franchise agreement) and the franchisee suffers an injury (e.g., loses money), then the franchisor may be equitably estopped (under the doctrine of promissory estoppel) from invoking the benefit of the "no oral modification" clause.

Generally, if a party knowingly and intentionally relinquishes one of its rights under the contract, that party may be deemed to have waived its contractual right. However, if the contract (e.g., franchise agreement) contains a "no waiver" provision, then the "no waiver" clause is generally enforceable and will typically override the course of conduct (and "waiver" of rights) being alleged.

Law stated - 31 August 2022

Renewal

What rules and restrictions govern the renewal of franchise agreements?

As New York does not have a so-called "relationship law," there is no statutory right of renewal in the State of New York. Rather, the terms of the contract agreed to by the parties will determine what, if any, renewal rights a franchisee may have after the franchise agreement expires.

Law stated - 31 August 2022

Sale and transfer

What rules and restrictions govern the sale and transfer of a franchised business?

A current franchisee who offers to sell, or sells, its franchised business for its own account may be exempt from the registration provisions of the New York Franchise Sales Act (NYFSA) if certain conditions are met: if the sale is an "isolated sale" (not part of a plan of distribution of franchises); the sale is "not effected by or through a franchisor"; and the franchisee discloses the potential buyer with the franchisor's then-registered FDD at least one week before any agreement is signed or money exchanged for the sale. N.Y. GBL § 684(5).

However, in practice, it rarely happens that the franchisee seller discloses the prospective buyer with the FDD since the current franchisee is usually contractually prevented from directly selling the rights and obligations of the franchisee seller's agreement to a prospective buyer. The franchise agreement typically requires, as a condition of any transfer, that the buyer sign the franchisor's "then-current" form of franchise agreement. In such a case, the franchisor—not the franchisee seller—would be required to disclose the buyer with the FDD.

While a franchisor is prohibited from making earnings claims that are not contained in the FDD, a current franchisee is permitted to disclose any financial information that it chooses to disclose (typically, financial statements and tax returns) relating to its franchised business to the prospective buyer (even though such information is not contained in the franchisor's FDD).

Law stated - 31 August 2022

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Integration and no-reliance clauses

What effect do integration and no-reliance clauses in franchise agreements have on claims of prior oral misrepresentations?

Specific disclaimers and no-reliance clauses are more effective than general, boilerplate integration and no-reliance clauses that purport to disclaim all pre-contract representations that are not memorialized in the written contract. For this reason, new franchisees are often required by the franchisor to fill out and sign a detailed questionnaire stating with specificity what, if any, oral representations may have been made to them prior to signing the franchise agreement, or that no representations with respect to "this, that or the other" were made.

Integration and no-reliance clauses can potentially defeat common law fraud claims that a franchisee may wish to assert based on alleged pre-contract misrepresentations. However, the NYFSA includes an anti-waiver provision that prohibits a franchisor from requiring that its franchisees waive liability under the statute. See NY GBL § 687(4), (5). Accordingly, there is a strong argument that integration and no-reliance clauses cannot preclude a franchisee from asserting NYFSA § 687 claims (i.e., involving fraudulent or unlawful practices) arising from the franchisor's prior oral misrepresentations. At a minimum, though, such clauses may call into question whether the franchisee reasonably relied on the franchisor's pre-contract misrepresentations.

Law stated - 31 August 2022

Good faith and fair dealing

How have the courts and legislature in your state dealt with the implied covenant of good faith and fair dealing in relation to franchises?

The implied covenant of good faith and fair dealing is implicit in all contracts entered into under New York law. Pursuant to said "implied covenant," the franchisor and franchisee may not engage in any conduct that seeks to deprive the other of the right to receive the fruits of the franchise agreement (the so called "benefit of the bargain"), so long as the complained of conduct is not expressly permitted under the agreement. In the franchise context, claims for breach of the implied covenant are most often made with respect to provisions that grant the franchisor sole discretion with respect to how it may choose to perform under the agreement. The implied covenant requires that any such discretion by the franchisor not be exercised arbitrarily or irrationally.

New York does not have a franchise relationship statute. So, common law claims for breach of contract and breach of the implied covenant of good faith and fair dealing are some of the most common and effective claims that franchisees can avail themselves of if the franchisor does not meet its obligations under the franchise agreement. Technically, New York law treats a claim for breach of the implied covenant as if it were a breach of the underlying contract, such that when a complaint alleges both a breach of contract and a breach of the implied covenant which are based on the same facts (and seeks the same relief), the claim for breach of the implied covenant will be dismissed as redundant.

Law stated - 31 August 2022

IP AND DATA PROTECTION

IP protection

How can franchisors protect and enforce their IP rights?

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The New York Franchise Sales Act's definition of a franchise contains two prongs: one prong is a fee; the second prong is either a marketing plan or the licensing of a registered trademark ("Where a franchisee, in return for a 'franchise fee', is granted the right to sell or distribute goods or services substantially associated with the franchisor's trademark, logo, advertising or other commercial symbol"). Undoubtedly, trademark registration and protection is a priority for New York-based franchisors. New York statutory and common law provides franchisors with a variety of options for protecting their trademarks.

New York franchisors may register their trademarks with the New York Department of State's Division of Corporations. Registering trademarks with the Division of Corporations is less complicated than seeking federal registration with the United States Patent and Trademark Office (USPTO). However, franchisors are well advised to seek federal registration whenever possible given the broad interstate and international protections available to federally registered trademark owners (e.g., the presumption of ownership, the right to sue in federal court, and "incontestability" after five years of exclusive and continuous use, etc.). Unlike federal trademark registration, New York's trademark laws do not recognize an "intent-to-use" basis for registration; a trademark application cannot be filed in New York until the trademark has already been used in commerce. Notwithstanding this fact, New York State has a well-developed body of law surrounding the protection of both registered and unregistered trademarks.

New York's General Business Law provides a broad variety of remedies under statutory and common law, including: injunctive relief; the destruction of infringing products; damages and disgorgement of profits; and in cases where infringement was committed with knowledge or in bad faith, the New York Courts have the discretion to award treble damages and attorneys' fees. (N.Y. Gen. Bus. Law. Section 360-m.) New York also has an anti-dilution statute that applies to both common law and registered trademarks as well as trade dress. (NY Gen. Bus. Law Section 360-l.) Trademark owners may also invoke causes of action under unfair competition (common law); false advertising (N.Y. Gen. Bus. Law Section 350.); product disparagement (common law); and unlawful deceptive acts and practices (N.Y. Gen. Bus. Law § 349(a).)

Law stated - 31 August 2022

Data protection

What rules and restrictions govern data protection and privacy in your state, and how do these apply in the context of franchising?

New York State's Information Security Breach and Notification Act (the "Notification Act") provides that state residents have the right to know when a data security breach as resulted in the exposure of their private information (i.e., social security numbers; driver's license numbers; credit and debit card numbers, including any security codes; in combination with any personal information concerning a natural person. In the event of such a breach, the affected state entity or business most notify affected consumers by written, electronic or telephone notification. If more than 5,000 consumers are affected, then the state entity or business must also notify certain credit reporting agencies.

In 2019, two additional laws were passed that expanded the Notification Act: the "Stop Hacks and Improve Electronic Act" (SHIELD) and "Identity Theft Protection and Mitigation Services Act" (the Mitigation Act).

SHIELD expands the Notification Act by expanding the obligation to all persons and businesses that handle New York State residents' information, regardless of whether the person or business conducts business in the state. SHIELD also requires such persons and businesses to implement and maintain reasonable administrative, technical and physical safeguards for consumer information. A franchisor's failure to establish reasonable safeguards may lead to action by New York regulators against the violating party.

The Mitigation Act provides that, if a business regulated as a Consumer Reporting Agency is affected by a data privacy breach, it must provide five (5) years of identity theft protection and mitigation services to any persons affected by the

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breach.

New York does not currently have a comprehensive data protection statute. However, over the last few legislative sessions, including in 2022, several versions of the New York Privacy Act (NYPA) have been under consideration. In its current iteration (Senate Bill 6701B), the NYPA would require companies to disclose their methods of de-identifying personal information, to place safeguards around data sharing and to allow consumers to obtain the names of all entities with whom their information is shared.

Law stated - 31 August 2022

Cybersecurity

What legal and practical considerations should franchisors bear in mind to address cybersecurity threats?

High profile data breaches have become a common news occurrence, with franchisors such as Dairy Queen, Jimmy Johns, Marriot, Hyatt, and Panera being victims of cybercrime. Therefore, franchisors should treat cybersecurity threats as a material risk. In fact, SHIELD (described above) requires businesses to take reasonable security measures to protect personal data.

Ransomware threats, in particular, have been on the rise. Nationwide, the rate of ransomware attacks increased 144% from 2020 to 2021. During a ransomware attack, criminals take advantage of data security flaws to lock a target's access to its data; only to provide access in exchange for the payment of a ransom. Currently, NY State Senate Bill S6806A (2021-2022 Legislative Session), which, if passed, would prohibit governmental entities, business entities and healthcare entities from paying ransom in the event of a cyber incident.

A franchisor has an obligation to support its franchisees against cybercrime threats (including ransomware attacks) not only because data breaches at the franchisee level will negatively impact upon the franchisor, but also because there is the risk that liability incurred at the franchisee level may be imputed to the franchisor. Franchisors should consider the following "best practices":

- keeping aware of changes in data protection laws;
- obtaining cyberthreat insurance, if available;
- implement multi-factor authentication with respect to all user accounts;
- updating franchisee training to include data security programs; and
- updating franchise agreements to require franchisees to utilize appropriate data protection and security.

None of these measures are foolproof and the franchisor should be careful to balance the protection of its franchisees against the risk of potentially incurring vicarious liability by interfering too much in franchisees' independent practices.

Law stated - 31 August 2022

COMPETITION LAW

Applicable laws

What competition and antitrust laws apply to franchises in your state?

On the federal level, the major antitrust statutes that impact franchising are the Sherman Act, (15 U.S.C. §1 et seq.) (generally prohibiting anti-competitive or monopolistic conduct), the Clayton Antitrust Act (15 U.S.C. §§12 et seq.) and the Robinson-Patman Act (at 15 U.S.C. §13) (generally prohibiting anti-competitive price discrimination, exclusive

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dealing, and tying). In New York State, the major antitrust statute is the Donnelley Act (N.Y. G.B.L. §§ 340-347) (generally prohibiting price fixing, bid rigging, monopolization and tying arrangements et al.) However, antitrust matters have not been a hotly litigated franchise area in recent years. In most circumstances, the presence of a clear franchise agreement and a transparent Franchise Disclosure Document (FDD) that includes contractual requirements to purchase specific goods, or restraints on conducting business, will overcome most antitrust claims.

On July 9, 2021, President Biden signed an executive order "encouraging" the FTC to limit restrictive covenants. Moreover, there have been recent bills introduced in the Senate and House aimed at limiting non-compete agreements. Despite growing pressure at the federal level to curtail non-compete agreements, New York franchise agreements can still, for now, incorporate restrictive covenants. As stated by the Court of Appeals, for a restrictive covenant to be enforceable in New York, it must be "reasonable", a standard that applies the following three-pronged test: "(1) it is no greater than is required for the protection of the legitimate interest of the employer; (2) does not impose an undue hardship on the employee; and (3) it is not injurious to the public." BDO Seidman v. Hirshberg , 93 N.Y.2d 382 (1999). Determining the enforceability of a particular covenant is case specific and courts often will "blue pencil" an agreement to remove unenforceable provisions. Id.

Law stated - 31 August 2022

EMPLOYMENT AND LABOR

Joint employer liability

How have the courts and legislature in your state addressed the issue of joint employer liability in the franchising context?

As anticipated, with the new Biden administration coming into power along with the "changing of the guard" at federal agencies (including new appointments by the Biden administration), the joint employer standards have again shifted (or are in the process of shifting) at the federal level. The Biden administration is apparently returning to the standard under the 2015 NLRB matter called Browning-Ferris Industries, whereby a franchisor could be considered a joint employer—even it if only exercised "indirect" control over a franchisee's employees, including the "ability to exercise such control." Such indirect control is troublesome in the franchise industry, since it is typically necessary for a franchised system to exert some degree of control over the operations of its franchisees. Although the Trump administration sought to reverse this course (including by promulgating rules through multiple federal agencies, including the U.S. Dept. of Labor (DOL), and the EEOC), it did not do so until February 20, 2020, when the NLRB issued a new joint employer rule under the National Labor Relations Act (NLRA), which removed the prior "indirect" control language, and in relevant part states "the entity must possess and exercise such substantial direct and immediate control over one or more essential terms or conditions of their employment . . ." It was a New York federal court, in a suit brought by multiple state Attorney General's offices, that ultimately struck down much of the Trump administration's 2020 rulemaking (led in large part by New York's AG's Office), in State Of New York et al v. Scalia , Index No. 1:20-cv-01689-GHW (Sept. 8, 2020). In late July 2021, the Biden administration formally rescinded the prior 2020 DOL rule, reverting back to the 2015 standard. See DOL Notice for 29 CFR Part 791, RIN 1235-AA37 (July 29, 2021) ("This action finalizes the Department's proposal to rescind the final rule titled "Joint Employer Status Under the Fair Labor Standards Act," which was published on January 16, 2020, and took effect on March 16, 2020. This rescission removes the regulations established by that rule."). Other federal agencies have already, or are in the process of, doing the same. Therefore, franchisors and franchisees should assume that the Browning-Ferris standard applies on the federal level, and adopt a more protective stance.

New York also has its own state and local wage and hour laws, such as the New York Labor Law (NYLL), and antidiscrimination laws, such as the New York Human Rights Law, along with their own independent versions of the "joint employer" doctrine, under which New York courts have often looked to the federal standard for guidance. See,

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e.g., Brankov v. Hazzard , 2016 NY Slip Op 05778 (App. Div. 1st Dept. Aug. 11, 2016). So, while New York often looks to the federal statutes for guidance, the liberally construed labor statutes of New York state, and notably, New York City, are not required to follow federal rules, and with New York aggressively pursuing a more liberal approach to joint employer status, it may be prudent to take the cautious approach and assume the broader interpretations of "joint employer" are applicable. Franchisors should consult with knowledgeable franchise counsel, and exercise caution where some control over a franchisees' employees may occur, particularly within the realms of wage and hour, labor relations, or other terms and conditions of their employment.

Importantly, franchisors should remember that joint employer liability is a problem with a solution grounded in how much control a franchisor ought to exert over its system. The application of the joint employer doctrine is limited to issues within the employment context, and therefore, it only has the potential to impact those franchisors who directly—or indirectly (given the likely standard)—exert control over the terms and conditions of their franchisees' employment relationships. Franchisors who specifically choose to involve themselves in opposing the union activities of employees of their franchisees, or mandate that franchisees' employees work certain hours or at certain pay rates, or become involved with collective bargaining with respect to their franchisees' employees, are very likely asking for trouble. Franchisors that do not seek to impose any significant control over the employees of their franchisees, especially in the labor relations arena, or wage and hour concerns, will significantly reduce their risk of being considered joint employers, or subject to NLRB scrutiny or NLRA liability. Regardless, Franchisors who are contemplating such actions, ought to consult with counsel, particularly where it seeks to exert some control over a franchisees' employees, particularly within the realms of wage and hour, labor relations, or other terms and conditions of their employment.

Law stated - 31 August 2022

Other employment and labor laws

Are any other employment and labor laws particularly relevant to franchises in your state?

In the current pandemic climate of COVID-19, the employment relationship has been impacted by executive orders issued by governor's offices, legislative acts, and local mandates, mandating certain conduct with respect to how employees must conduct themselves in the COVID-19 pandemic. Importantly, this means that system standards may have to change temporarily (or permanently), in order to ensure compliance with governmental mandates designed to protect both employee safety, as well as general customer safety. As of the writing of this article, New York had been poised to "reopen"—indeed even celebrated its "phased" return to normalcy, only to see its infection rates climb again, largely due to the new "delta" variant of COVID-19, with its higher rate of transmissibility. As it stands now, New York's health and safety requirements are shifting on an almost daily basis.

What has made this all the more complex in New York, is the June 14, 2021 signing into law of the New York Health and Essential Rights Act, or NY HERO Act (as amended), which modifies the New York Labor Law (NYLL) to require compliance with health and safety regulations (requiring employers to implement a "plan" for essentially ensuring employee safety – either using a template provided by the NY DOL, or an alternative template developed by the employer that complies with health and safety regulations. It further provides significant new protection for employees. Employers cannot "discriminate, threaten, retaliate against, or take any adverse action" against employees for, inter alia, exercising their rights under the Act or the employer's plan, reporting violations of the Act or the employer's plan to officials, reporting or seeking assistance for an airborne exposure concern to an employer or official entity, or refusing to work when the employee (in good faith) believes that a dangerous exposure caused by working conditions is inconsistent with laws or the required safety plan. This new right also comes with penalties for violations, along with, significantly, a private right of action for employees. This means employees have significant new rights in this regard, and employers must be particularly cautious. Franchise systems operating in New York must adapt to this new law, and must allow franchisees to adjust operations to meet these requirements, which, is of course particularly difficult with ever-changing guidance.

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The only guidance that seems prudent, particularly in New York City, which has its state—and often own local (sometimes different) health and safety standards, is for franchisors to ensure that they do not seek to require anything that might conflict with local, state, or federal COVID-19 related mandates, including health and safety measures. Normally, properly crafted franchise agreements require a franchisee to comply with all local rules and regulations, and any system requirement that conflicts with them is void. However, franchisors and franchisees alike must be guided by their localities' restrictions, and make sure that system standards are adjusted to adhere with what is required under pandemic-related restrictions. This may, importantly, include operations manuals, which should be modified to reflect that an overriding requirement is compliant with health and safety measures that may be in effect in each locality, and each franchised unit must be mindful of its employees' rights, including rights that exist under the ADA, FMLA, and other applicable statutes and local laws (including, significantly, New York's Mini-FMLA, New York Labor Law, and Human Rights Law (with its new "caregiver" protected status), in conjunction with the COVID-19 pandemic (such as paid leave, "caregiver" acts, and other statutes and executive orders that give employees rights to stay at home, take leave to care for an impacted person under their care, prohibit discrimination (including with respect to working from home, taking leave, having a disability, or caring for children or sick loved-ones), or that require a level of safety at the workplace, including for those who are immune-compromised and therefore may be protected as "disabled"). Franchisees face a very difficult task in having to navigate these waters, and franchisors should generally try and help struggling franchisees, but should also be very cautious about mandating a course of action (lest they become independently liable for requiring acts that amount to COVID-19 health and safety law violations, or inadvertently becomes joint employer, see above).

Franchisors must be flexible, and work with their franchisees in each jurisdiction, including New York (with its own unique labor and employment laws), as each jurisdiction may be markedly different, particularly within the COVID-19 context. Cooperation between franchisors and franchisees is a necessity in this uncertain climate, and franchised systems should do what they can to minimize the financial impact of the virus, protect their franchisees' employees, and protect brand image and reassure customers by working together so that each franchisees' employees are doing what is required by local authorities, and as customer and employee safety requires.

Another area where employment law will become a factor is within post-term restrictive covenants. New York generally allows post-term restrictive covenants. In New York, such clauses are disfavored, construed against the party seeking the restraint, and will generally require a fact-intensive inquiry. Often franchisors seek to impose restrictive covenants not only upon a business, but also upon a former franchisee's principals, family members, and key employees (or employees in general). Restrictive covenants targeting a person's right to work must be reasonable in both geographical and temporal scope, as well as being necessary to protect a franchisor's legitimate interest. Generally, a "blue pencil" provision in any such restraint, allowing a court to modify any such clauses to provide the maximum protection allowed under the law, assuming such a clause is even enforceable, is prudent. Now, while no prohibition exists in New York to having such covenants, enforcement may be difficult, costly, and unsuccessful where a franchisor (or franchisee) seeks to apply such clauses to a franchisee's principals, family members, and key employees (or employees in general). Franchisors and franchisees should carefully consider whether an action to enforce such contractual provisions is wise or cost-effective. In addition, franchisors and franchisees need to be prepared, particularly in New York, to seek to require such restrictive covenants in their franchisee's agreements, lest they run afoul of anti-competition statutes. New York has its own anti-competition prohibitions, and there are also legislative initiatives that are actively seeking to ban such restrictive covenants altogether. (See, e.g., NY S6425, prospective legislation seeking to ban certain employment related restrictive covenants, and providing a private right of action for aggrieved employees). While no such law yet has been passed in New York, there are certainly indications that New York generally is becoming very hostile to restrictive covenants. Further, on the federal level, the Biden administration's July 9, 2021 Executive Order on Promoting Competition in the American Economy, signaled that the Federal Trade Commission (FTC) may now become active in utilizing its powers to regulate restrictive covenants under anticompetition laws. This will likely be an active area in the coming years, and franchisors will likely need to revisit their franchise agreements where restrictive covenants are mandated.

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REAL ESTATE

Laws and practical considerations

What real estate laws and practical considerations should franchises bear in mind when operating in your state?

New York is a complex real estate market which includes vast urban, suburban and rural areas. Real estate leasing (and purchasing) conditions may vary from region to region and are frequently affected by local custom. However, whether a franchisee is purchasing a location or entering into a lease for a location, in every scenario, the proposed location will be subject to the franchisor's approval (for which the franchisor typically will provide the franchisee with specifications and other requirements relating to the proposed location).

Typically, New York franchisees enter into commercial leases for their locations. Unlike residential leasing, which is governed by robust local and New York state laws, commercial leasing is largely left to the parties' freedom to contract. It is therefore advisable for franchisees to hire knowledgeable counsel to guide them through the difficult leasing process, especially given that a commercial lease will likely be the franchisee's largest financial commitment during the franchise process. The franchisee must also be prepared to address the franchisor's inevitable interest and involvement in the leasing process.

In urban areas such as New York City, the term of the lease may be lengthy—often for 10 years or more (not including renewal terms). In addition to a franchisee negotiating terms that are favorable towards itself (e.g., limiting the scope of a personal guaranty; and ensuring that the term and renewal terms are coterminous with the franchise agreement's term, renewals, etc.), the franchisee has the added burden of negotiating conditions that may be required by the franchisor. For example, many franchisors provide their franchisees with a "form of lease rider" and/or other ancillary documents for the franchisee and landlord to negotiate and incorporate into their lease. However, while this is a complex process, many landlords are generally aware that the franchisor will seek to reserve certain rights with respect to the franchisee's lease (e.g., the franchisor will usually seek the landlord's pre-approval to "step-in" to the lease in the event that the franchisee is in default of its franchise agreement), or arrange for an assignment of the lease to a new franchisee.

In some circumstances, the franchisor itself (or its affiliate) will be the franchisee's landlord—either because the franchisor owns the franchised location, or the franchisor is the primary leaseholder of the location (and subleases the location to its franchisee). From the franchisor's perspective, this has some advantages with respect to protecting the system and having more control over the franchised location (e.g., a franchisee in default of its franchise agreement may also be in "cross default" with respect to its sublease or lease). This situation will be less advantageous to the franchisee because of the fact that the franchisor, as opposed to an independent landlord, will have more control over the franchise location.

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The COVID-19 pandemic shattered the New York State commercial real estate market, particularly in New York City

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where prices (and rents) have, historically, always been at a premium. During the long stretch of lockdowns and capacity restrictions, New York franchisees, particularly small businesses, struggled to maintain operations and pay rent (and, in the case of landlords, pay their mortgages) in a climate of lockdowns, capacity restrictions and the disappearance of international and most domestic tourism. While the State and City of New York have lifted their restrictions, the commercial real estate market has not returned to business as normal because the desire for remote work has persisted and many corporate office-space tenants are questioning the amount of space they really need. However, with respect to non-office spaces there is indication that business is returning to normal.

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TAXATION

Applicable taxes

What tax liabilities arise for franchisors and franchisees in your state?

Franchises (and companies in general) that operate in New York State are subject to a corporate income tax, sometimes called a “franchise tax.” Calculating New York’s corporate income tax is more complicated than may be the case for similar tax structures in other states. In New York, one must pay the highest amount calculated under the following three alternative tax bases: business income; investment capital base sometimes called “business capital”; or a fixed dollar minimum tax. Business income’s tax base begins at the same point as the federal tax base, adjusted by New York specific additions and subtractions. The presumptive business income tax rate is 6.5%, with varying rates for certain sectors.

A corporation can also elect to be treated as an S corporation in New York State and would be subjected to the fixed dollar amount tax base that all S corporations must pay.

Franchisees and franchisors that are part of a multi-state model should note that from 2015 onwards New York State has used “market-based sourcing” that allocates business income to a single receipt that is based on customer location. New York City based franchises also have some variations in tax rates and methods that differ from the rest of New York State (i.e., in New York City, S Corporations and Partnerships/LLC use “place of performance” for the sourcing of service receipts).

Law stated - 31 August 2022

Nexus

How is nexus defined for state tax purposes, and how does this affect liability for state income tax on franchisor royalties?

New York law provides that any company engaging in “economic activity” in the state, including having an office, owning or leasing property, doing business in the state, or deriving receipts (of $1 million or more in a tax year) from activity conducted in New York is considered to have a New York nexus for state corporate income tax considerations. Franchisors that sell goods and services, or licenses to franchises located in the state are not specifically exempt from the tax and may be subject to the same tax provisions as any other business that conducts activities in New York. We recommend that franchisors discuss these issues with an accountant or tax advisor who is familiar with the franchisor’s business.

As of January 2019, for sales tax considerations, New York deems a business without a physical presence to have a New York nexus if it has New York sales revenue of tangible personal property exceeding $500,000 as well as 100 sales of tangible property, during the immediately preceding four sales tax quarters. Such a business is required to register as a sales tax vendor. New York State requires all franchisors to make an annual filing regarding its sales and

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royalties (the “Information Filing”) if they are required to register as sales tax vendors and have at least one New York franchisee. The Information Filing, among other things, includes: the amount of royalty payments, if any, made to the franchisor for each franchise location; and for each franchise location, where applicable, the royalty percentage of gross sales reported. If royalty payments are based on a computation other than a percentage of gross sales, the details of that computation should be provided.

The COVID-19 pandemic has brought about a major and, likely for many workers, a permanent shift to telecommuting and has raised questions relating to nexus. New York State released guidance in late 2020 that stated that for days where nonresidents are telecommuting and whose primary office is located in New York, they are considered days worked in the state, under the “convenience of the employer” rule rather than as a requirement of the employer. See Zelinsky v. New York Tax Appeals Tribunal, 801 N.E.2d. 840 for where the “convenience of the employer” rule was affirmed.

Law stated - 31 August 2022

DISPUTE RESOLUTION

Common disputes

What issues are typically the subject of disputes between franchisors and franchisees in your state?

Since the NYFSA is a disclosure statute, and not a relationship statute, the most common franchisor-franchisee disputes relate to Franchise Disclosure Document (FDD) disclosure (or the lack thereof) and registration issues, and pre-contract misrepresentations and/or omissions that the franchisee relied upon in entering into the franchise agreement. Franchisees often assert claims under Section 683 of the New York Franchise Sales Act (NYFSA) for a franchisor’s failure to make proper disclosures in its FDD and under Section 687 for pre-contractual misrepresentations and/or omissions made by the franchisor.

Franchisees routinely assert common law claims for negligent misrepresentation and fraud if the franchisor made pre-contract misrepresentations or omissions. If the franchisor fails to provide the ongoing support and training that is required under the contract, the franchisee may sue for breach of contract or breach of the implied covenant of good faith and fair dealing. However, these common law claims are often more difficult to establish and the potential recovery is not as great, especially since there is no common law right to recover a party’s costs and expenses, including attorneys’ fees. For common law claims the franchisee will only recover its costs and expenses if the franchise agreement contains a “fee shifting” provision and the franchisee is the prevailing party.

Franchisors often assert breach of contract claims against wayward franchisees. Such claims typically arise if the franchisee fails to pay its royalties or adhere to the system’s operations standards. To the extent that the franchisee does not cure its defaults and the franchisor then terminates the franchise agreement, the agreement often mandates compliance with a variety of post-termination obligations. If, for example, the franchisee fails to promptly de-identify, the franchisor may seek damages (which may include both treble damages and attorney’s fees) or an injunction for trademark violations under the federal Lanham Act; the franchisor may also seek to enforce a non-compete provision if it has a legitimate business interest to protect.

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Venue and governing law

What legal and practical considerations should be borne in mind when choosing a litigation venue and governing law for franchising disputes arising in your state?

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As a practical matter, the franchisor usually prefers to apply the law of its home state to the franchise agreement, and to litigate any franchise disputes in a venue near its corporate headquarters. The advantage to the franchisor is that it and its counsel will ordinarily have an in-depth understanding of the local state law. Additionally, the franchisor can enjoy the convenience of having its witnesses nearby and available for a trial or arbitration. Often there is a carve-out in the contract permitting the franchisor to sue the franchisee in its home state for claims relating to enforcement of a non-compete provision or the franchisor's post-termination trademark rights, where injunctive relief may be sought.

If either the franchisor or franchisee is located in the State of New York, the New York Franchise Sales Act (NYFSA) will apply regardless of what the governing law provision of the franchise agreement may say. Further, New York requires an addendum or rider to the franchise agreement which states, in part, that the choice of law provision does not constitute a waiver of the parties' rights under the NYFSA. However, notwithstanding the NYFSA's anti-waiver provision, a venue provision that designates a forum outside of New York may be enforceable.

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Document retention

What document retention considerations and policies are pertinent for parties to franchise-related litigation in your state?

Once a party reasonably anticipates litigation, it must suspend any automated deletion processes for its electronic data (e.g., the purging of emails) and institute a "litigation hold" that will preserve all potentially relevant documents in their hard copy or electronic form. It is not enough for a company to direct its employees to initiate a litigation hold; counsel must oversee the process (with the technical assistance of competent IT professionals) to ensure that the litigation hold is being properly implemented.

There is no bright line rule as to when a party can be said to have first "reasonably anticipated litigation," but, in the franchise context, the issuance of a demand letter, a default notice, and/or a termination notice, in addition to a notice directing the opposing party to implement a litigation hold, likely triggers the duty to preserve.

In franchise disputes—unless the franchisee has been terminated—the parties continue to have an ongoing business relationship and, so the preservation of documents is complicated by the fact that the franchisor may have control or access over certain of the franchisee's documents. For example, the franchisee's business emails may be on the franchisor's server, and the franchisee's POS system may offer the franchisor a direct feed to the franchisee's business information. In that respect, the franchisor has a distinct advantage. If the franchisor terminates the franchisee's franchise agreement, the franchisor may (and often does) lock the franchisee out of its company email account and deny the franchisee further access to its business emails and/or POS system. In anticipation of a threatened termination, the franchisee should "back up" its emails and business information so that it is not fully in the dark if and when litigation is commenced.

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Remedies

What remedies are available and commonly awarded in franchise-related litigation?

The NYFSA offers aggrieved franchisees powerful statutory claims that franchisees can utilize to gain redress for the franchisor's violation. If a franchisee prevails on its NYFSA claims, it can recover damages. However, if the franchisor's violations are found to have been both wilful and material, the franchisee may also be entitled to rescission of the franchise agreement and other related agreements (a restoration of the status quo ante). Additionally, a franchisee can recover 6% statutory interest from the date of purchase, together with attorneys' fees, and court costs. It is significant,

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given the typically unequal financial resources of the franchisor and franchisee, that only the franchisee has a statutory right to recover its attorney fees if it prevails under its New York statutory claims.

Franchisors may recover damages for breach of contract. If the franchisee wrongfully terminates the franchise agreement prior to expiration of the term, the franchisor may even be entitled to recover lost future profits (including the lost royalties stream for the duration of the franchise term). Franchisors will often aggressively seek an injunction and damages for any post-termination failures to de-identify, return the company's confidential materials, and/or abide by the terms of any restrictive covenant.

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Alternative dispute resolution

Is alternative dispute resolution (ADR) commonly used for franchising disputes in your state? What considerations should be borne in mind when opting for ADR?

Many franchisors prefer to litigate their franchise disputes in the relatively private confines of an arbitration proceeding rather than in open court. In theory, if not in practice, arbitration is more cost effective and expeditious than litigation in court (where motions and appeals may predominate) would be for the parties. Accordingly, the dispute resolution provision in most franchise agreements provides that the parties must submit their dispute to arbitration. Sometimes, dispute resolution provisions also require, as a condition precedent, that the parties first engage in mediation before an arbitration is commenced. Typically, the dispute resolution provision has a carve-out granting the franchisor the right to seek an injunction and sue for trademark violations, and/or breaches of restrictive covenants, in court.

If the franchisor requires arbitration in its dispute resolution provision, it should consider whether to expressly require that claims against the principals, officers and employees of the franchisor be brought in the same arbitration forum. This is especially important in New York since the NYFSA grants franchisees the right to sue, not just the franchisor, but also the franchisor's "control persons" and any employees who materially aided in the statutory violation. NYFSA § 691(3).

Some arbitration provisions call for a three-arbitrator panel, which can increase the costs of an arbitration significantly. Discovery is usually more limited and the rules of evidence are "relaxed" in arbitration. Further, the ability to set aside an arbitration award is severely limited as the legal standard for doing so is making a showing that the arbitrator issued the award in "manifest disregard of the law" (which means showing that the law was clear, that the arbitrator knew what the law was, but that he or she intentionally disregarded the law). Accordingly, motions to vacate or modify arbitration awards are uncommon, and when they are made, they are often made for "strategic" or "settlement posturing" purposes. Despite these factors, arbitration remains a popular means of resolving franchise disputes in the State of New York.

Before the prevailing party in an arbitration can enforce an arbitration award in New York, a petition to confirm the arbitration award must be filed in New York state court within one year of the award's issuance. CPLR § 7510. Then, the court's judgment confirming the award must be filed and entered in the office of the county clerk.

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UPDATE AND TRENDS

Key developments of the past year

What have been the most notable recent developments and trends in relation to franchising in your state?

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The COVID-19 pandemic continues to be the most notable development, and continues to impact virtually every aspect of business in the U.S. Almost every franchised system has had to adjust or adapt in some way. There continues to be uncertainty about the future, and with the introduction of the Delta variant, the situation is constantly evolving. At the time of this article, there also remains a significant discrepancy between regions with respect to how impacted they are by the pandemic, and franchisors and franchisees (and would-be franchisees) should carefully assess the conditions in a specific region. However, there is hope that the worst impacts of the pandemic are behind us, particularly as the U.S.'s vaccination rates climb, and indications are that COVID variants are responding well to existing vaccines, or imminently available booster shots. Economic forecasts for the U.S. are relatively strong, and franchising may provide a very attractive option for those looking to enter marketplaces that are now less saturated, particularly where competition has not survived the pandemic. Franchised systems, by virtue of having proven methods of operation and high brand recognition with established marks, have a distinct advantage in market entry as industry and business restarts. Customers are far more likely to inherently know what a franchised business offers, particularly over unknown and unproven start-ups. Therefore, many in the industry are anticipating an increase in franchising, and purchases of franchised units in established brands.

The COVID-19 pandemic has also, for better or worse, hastened the transition to e-commerce in most industries. Some systems have not been able to adapt, and others find that their customers now expect to purchase goods and services entirely online. Traditional "brick and mortar" models may need to adjust to survive in the new economic climate. However, with the contraction of many office spaces (as more people work from home), and loss of many retail businesses, commercial real-estate may be more affordable, at least in the near term. The concept of a set geographic "territory" is also becoming more fluid in franchising with e-commerce increasingly driving sales. Franchised systems may need to take a hard look at how their franchised territories are defined, and how e-commerce is addressed in franchise agreements, not only to understand the present, but to also plan for the future growth of the franchise. The new reality is that businesses without an e-commerce component are generally now at a significant disadvantage, and if franchisees under an older system model are prohibited from engaging in e-commerce, or a franchisor is competing against its local franchisees, individual franchised units may not be able to survive.

Other factors that are just beginning to be understood in franchised businesses, are the impacts of the pandemic on demographics and customer population distribution. There have been changes to, and in many instances, significant declines in commercial foot traffic and commuter business. This is usually more pronounced in urban locations or city centers where businesses rely upon commuters for business. Many people are now working from home, or in hybrid arrangements, and therefore are not commuting as often. This is reducing customer bases in locations that previously could count on high levels of foot traffic or commuter business. It remains to be seen if these trends subside, and the workforce returns to previous levels of commuting, or if this has become a more permanent aspect of the U.S. economy. Previously lucrative franchised territories may now be untenable. In contrast, opportunities may now present themselves in areas where people previously rarely sought to eat out, or purchase goods or services, but there now exists a new demand. For example, areas where workers reside, who are now working from home, may be far more lucrative than before. Franchisors and franchisees are going to have to pay close attention to these trends. Systems should try and mitigate against negative shifts in customer demographics, as well as be poised to take advantage of any "new normal" trends that may emerge.

The pandemic is not over, and with the Delta and other variants still threatening to complicate matters, franchisors and franchisees continue to be well-advised to cooperate with each other and adjust system standards to function wherever practicable based upon a locality's governmental mandates, employee and customer safety, liability concerns, and customers' new preferences and needs. Franchisors and franchisees should remain in active communication, provide insight as to how to adjust the franchise model as necessary, and franchisors would be well-advised to have a forum for discussion about what works (and what does not). Franchisors should also consider what steps might be prudent to ensure survival of their franchised units (who may be under extreme financial pressures), and be willing to relax or altogether alter system standards. Struggling franchisees may be saved by a franchisor's judicious temporary deferment or reduction in royalties or other payments, and survival of a unit in the long run benefits franchisors and

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franchisees alike.

It is a possibility that certain franchised systems may never recover from COVID-19, or that they cannot recover in their present form and must significantly change their system. Franchisors in this position are well advised to listen to their franchisees for ideas and potential guidance as to changes that can be made, or must be made, and decide if they are possible or practicable. To fit within the “new normal” adaption is a necessity, and one of the greatest strengths of a functional franchised system, is the ability of a franchise to draw upon all of its franchisor’s expertise and existent developed model, as well as a system’s individual franchisees’ ideas and experiences. Franchisee associations can provide much needed insight and potential ideas that can positively impact an entire system. A franchised system at its best is a community, where no single business should feel alone or abandoned during a crisis, and shared leadership and ideas may be the most valuable asset for franchises in weathering the COVID-19 crisis.

In addition to COVID-19 related developments, there have been several other notable issues and trends. The joint employer doctrine continues to be an issue in franchising. While federal regulators have now moved for a more aggressive concept of “joint employer,” the feared associated onslaught of litigation has not yet materialized. However, this remains a hot topic, and franchisors should continue to be wary of pitfalls associated with becoming a joint employer. Another area deserving of attention is non-competition clauses (including “no-poaching” provisions in franchise agreements that restrict franchisees from hiring the employees of another franchisee in the system). These provisions continue to be scrutinized by regulators. Franchisors and franchisees alike should really examine whether such clauses are truly necessary, or are even enforceable. It may be that the benefits of having these no-poach provisions, which previously were often considered “standard,” may not outweigh the risks or costs of enforcement.

Finally, lurking in the background of COVID-19 and the increased use of e-commerce, are the perils of cybersecurity breaches and online crime. Cyber-threats and online crime continue to increase in the U.S., and 2020 was no exception, with 2021 trending upwards as well. While the attention of the nation has rightfully been upon COVID, franchised systems continue to be a target of malicious cyber-attacks, particularly where customer information and online sales are at risk. With many workers now working online, and away from centralized locations, the risks of compromise has increased. Franchised systems also inherently have a centralized franchisor, and often, each franchisee, all of which can be access points if systems are interconnected. This may place franchised systems at greater risk of compromise. Franchisors should continue to insist upon best practices to avoid any data breaches where customer information is stored, and retain competent IT professionals to safeguard systems.

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Jurisdictions

Jurisdiction	Firm
USA - Arizona	Gust Rosenfeld, PLC
USA - Indiana	Ice Miller LLP
USA - New Jersey	Rosen Karol Salis, PLLC
USA - New York	Rosen Karol Salis, PLLC
USA - Texas	Polsinelli PC

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