PRACTICE GUIDES

Franchise

Editor
Philip F Zeidman

LEXOLOGY®
Getting The Deal Through

Franchise

Practice Guide

Editor

Philip F Zeidman

LEXOLOGY®
Getting The Deal Through

Publisher
Tom Barnes
tom.barnes@lbresearch.com

Subscriptions
Claire Bagnall
claire.bagnall@lbresearch.com

Senior business development managers
Adam Sargent
adam.sargent@gettingthedealthrough.com

Dan White
dan.white@gettingthedealthrough.com

Published by
Law Business Research Ltd
87 Lancaster Road
London, W11 1QQ, UK
Tel: +44 20 3780 4147
Fax: +44 20 7229 6910

First published 2019
First edition

ISBN 978-1-83862-190-2

Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112

Acknowledgements

The publisher acknowledges and thanks the following law firms, advisory firms and corporations for their learned assistance throughout the preparation of this book:

ARCO ABOGADOS Y ASESORES TRIBUTARIOS SLP

BARNES & THORNBURG LLP

DLA PIPER LLP (US)

DM KISCH INC AND KISCH AFRICA INC

ELLA CHEONG LLC

ELZABURU

FLINN

FOLEY & LARDNER LLP

GONZÁLEZ CALVILLO SC

GRAY PLANT MOOTY

GREENSFELDER, HEMKER & GALE PC

HAMILTON PRATT

HOLLAND & KNIGHT LLP

KENNEDY VAN DER LAAN

LAPOINTE ROSENSTEIN MARCHAND MELANÇON LLP

MCMILLAN LLP

PÉREZ ALATI, GRONDONA, BENITES & ARNTSEN (PAGBAM)

SOUTO, CORREA, CESA, LUMMERTZ & AMARAL ADVOGADOS
(SOUTO CORREA ADVOGADOS)

STEWART GERMANN LAW OFFICE

Contents

Preface.......1
Philip F Zeidman

Part 1: Regulation of Franchising around the World

1 Global Overview of Specific Franchise Statutes and Regulations.......7
Philip F Zeidman and Tao Xu

2 Common Law and Civil Law on Franchising Issues.......20
John H Pratt

3 Good Faith and International Franchising.......29
Bruno Floriani, Marissa Carnevale and Tanya Nakhoul

Part 2: International Expansion by Franchising

4 Sub-franchising, Master Franchising and Development Agents.......41
Jorge Mondragón, Lucía Fernández and Pamela González

5 Selecting the Appropriate Vehicle for International Expansion.......50
Jorge Mondragón, Priscila Adalid and Lucía Fernández

6 Joint Ventures in International Franchising.......59
Mercedes Clavell

Part 3: Franchise Agreements

7 Confidential and Proprietary Information, and Trade Secrets 71
Mary Goodrich Nix

8 Covenants against Competition 83
Stewart Germann

9 Approaches to Resolving Cross-Border Disputes between Franchisee and Franchisor 95
Julia C Colarusso and Maisa Jean Frank

Part 4: M&A in International Franchising

10 M&A in International Franchising 109
Andrae J Marrocco

Part 5: Other Legal Considerations

11 Commercial Agency Distributorship Law 123
Beata Krakus

12 Data Protection and Privacy 131
Mercia Shannon Fynn

13 Consumer Protection 142
Luis Diego Barry and María Carolina Abdelnabe Vila

14 Competition Laws 153
Martine de Koning

15 Joint Employer and General Labour and Employment Issues 164
Marlén Cortez Morris and William M McErlean

16 Franchising and Insolvency 185
Jason B Binford

17 Electronic Commerce, Social Media and Franchising 193
Leonard Hawkes and Benoit Simpelaere

Part 6: Some Regional Perspectives

18 Franchise Registration Requirements in ASEAN Countries 209
Kevin Wong

19 Franchising in the European Union 221
Javier Fernández-Lasquetty Quintana and Alberto López Cazalilla

20 Franchise Disclosure Documents under Statutes in South America 229
Mariana Vicentini Taylor and João Carlos Arieira Harres

About the Authors 237

Contact Details 251

Preface

Philip F Zeidman[1]

In my introduction to *Lexology Getting The Deal Through – Franchise*, I described an experience many of us have had. I recounted a general counsel's arrival at the office to find a message from his boss, posing a series of questions about franchising in a number of countries around the world – questions to which the general counsel, understandably, has no ready answers. The same experience, of course, is familiar to outside counsel encountering a client's expectations.

A survey of the available sources of information comes up empty. None is sufficiently comprehensive yet digestible. *Lexology Getting The Deal Through – Franchise* seeks to meet that need by posing and answering the key questions one must address about franchising in a country. Now in its 13th edition, it covers 26 countries, and has proven its value many times over. It is a classic 'desk book' that belongs next to your telephone (if you still have one) or your computer.

But what then? After your rapid and impressive response, what happens when you need to delve more deeply into the issues raised by your company's or client's plan to expand by franchising? For that purpose, a book that provides succinct answers to threshold questions, however authoritative, is, as social scientists say, 'indispensable but insufficient'.

By now you know that franchising touches, glancingly or with full force, on almost every legal discipline. And you also know that none of those disciplines addresses franchising as squarely as you would like; that there are shockingly few law schools that include franchising in their curriculum; and that there are no course books that adequately cover the territory you will need to traverse.

Enter Lexology Getting The Deal Through's *Practice Guide – Franchise*.

If *Lexology Getting The Deal Through – Franchise* was designed to be left on your desk, *Practice Guide – Franchise* can perhaps best be thought of as the book you will take on your next flight.

So settle in.

Adjust your seat, your footrest and your reading light.

---

1 Philip F Zeidman is a partner at DLA Piper LLP (US).

You will almost certainly want to begin by examining the fundamental legal doctrines, statutes and regulations that govern how franchising is treated in law. That obviously requires an understanding of how different countries have chosen to regulate franchising explicitly (or declined to do so). So you begin with Global Overview of Specific Franchise Statutes and Regulations, which includes a handy chart at the end, keyed to the various approaches. But you will also want to step back and examine two broader and older legal constructs that are essential. One of those inquiries will be to learn how franchising is treated in the foundational legal structures of different countries, in Common Law and Civil Law on Franchising Issues. Under what circumstances will the analyses under those two systems lead to different results? And, you will need to have a grasp of another overarching theme, depending on how a country has chosen to apply it, or not, as the case may be (see Good Faith and International Franchising).

Now that you have an overview of the legal structures you will need to understand, it's time to get a sense of how franchisors go about selecting the form of expansion that best suits the company's business model, culture and management practices (Selecting the Appropriate Vehicle for International Expansion). One of those techniques – sub-franchising – is given special attention, not necessarily because it is the 'right' choice, but rather because it is the most complex of the hierarchy of approaches to expansion, and because it is much more commonly utilised in cross-border than in domestic franchising (Sub-franchising, Master Franchising and Development Agents).

It is also important to keep in mind that franchising is constantly evolving to take advantage of new techniques and approaches. Prominent among the new techniques are e-commerce and social media (see Electronic Commerce, Social Media and Franchising). There, as you will see, problems that arise are frequently owing to e-commerce not having been addressed adequately in the original franchise agreement and relationship.

The decision of how best to go about the business of expansion is, along with selecting the countries you wish to target, certainly at the threshold of your business and legal initiative. And understanding these critical 'first issues' will surely consume a sizable share of the time on your flight.

Now it's time to turn to the heart of the franchise relationship, and examine how the franchisor and the franchisee choose to express the bargain they have reached. Much of this process is understanding how elements of that bargain can best be articulated to leave as little as possible to be the subject of differing interpretations. But the parties are not entirely free to do whatever they wish, nor is one party free to demand that its wishes be adopted in all respects, because franchise laws and other bodies of law impose limits and restrictions on the parties. Some of the key provisions of the Franchise Agreement are discussed. Confidential and Proprietary Information, and Trade Secrets points out the pivotal role this plays in the essential intellectual property associated with the franchise, and the challenge to protect it in each country where the franchisor anticipates selling franchises. Special attention is given to Approaches to Resolving Cross-Border Disputes between Franchisee and Franchisor, including a separate chapter on the Choice of Law and Choice of Dispute Resolution Mechanism in Cross-Border Franchise Agreements.

Other bodies of law, of course, impinge upon franchising, and an understanding of how they interface is important to a competent franchise lawyer (see M&A in International Franchising). Consumer Protection begins by addressing the concept of a consumer, which may differ by jurisdiction, and discusses the consequence of applying consumer protection laws to franchising.

Data Protection and Privacy highlights the challenge presented to multinational franchisors in complying with the laws in this area adopted in nearly 120 countries, and suggests some approaches to meeting that challenge. Joint Employer and General Labour and Employment Issues examines the threat posed by this rapidly evolving field of law.

Among the subjects addressed by countries that have chosen to regulate franchising, the most common obligation is probably the duty to provide a prospective franchisee with information on the basis of which an informed investment decision can be made. The most robust embodiment of that obligation is the franchise disclosure document, discussed here in some detail in the chapter on Franchise Disclosure Documents.

Ladies and gentlemen, we are beginning our descent.

You have not, of course, been exposed to every nook and cranny of franchise law. That would require, at a minimum, several trips around the world.

But you can disembark now. You're off to a good start.

Part 3

Franchise Agreements

7

Confidential and Proprietary Information, and Trade Secrets

Mary Goodrich Nix[1]

Introduction

A franchise is simply not marketable without intellectual property rights. Confidential, proprietary and trade secret information that is special and unique to a franchise system is vital to its success. Without this level of intellectual property, there is no franchise concept of any value.

A typical goal of franchising is to rapidly expand a business concept in a cost-effective manner. The franchisee must be able to replicate the business operations of the franchise. All franchising agreements, therefore, involve the transfer of intellectual property to a franchisee for its use in carrying out the mission of the brand. Franchisors have the additional, competing goal of protecting the value of their intellectual property once it leaves its control and moves into the hands of a franchisee.

Intellectual property takes many forms in a franchise concept, but pivotal to the concept are its confidential information and trade secrets. The growing threat of trade secret theft requires a franchisor to become increasingly proactive in managing this threat. To effectively manage and meet their strategic, operational, expansion and financial goals, franchisors must develop a framework for protecting this valuable intellectual property from disclosure that will substantially decrease or eliminate the value of those secrets. Since intellectual property is the heart of a franchise, it is imperative that the franchisor protect its intellectual property rights in every possible way.

Internationally, the use of and threat of loss of trade secrets by franchisors has increased in recent years and, likewise, international litigation and arbitration over these intellectual property rights is increasing. However, there is little international agreement on what trade secrets are and about how to effectively protect against the risk of loss.

1 Mary Goodrich Nix is a partner at Holland & Knight LLP.

In developing its franchise agreement and other methods for protecting confidential information and trade secrets, franchisors must consider laws in each country where it contemplates selling franchises. The domestic laws of the target country may govern the entering into, the interpretation of and the enforceability of contracts. To protect its intellectual property, the franchisor must ensure that its agreements and trade practices comply with such laws. Moreover, certain formalities may be required depending on the country. For example, the franchise agreement may have to be in writing, in a certain language, and recorded with a particular government agency. Many countries have enacted laws that broadly regulate all contracts between local entities and foreign enterprises and these must be evaluated closely.

While there are means and methods in nearly every country for enforcing agreements and pursuing violations of statutes intended to protect misappropriated trade secrets, the savvy franchisor will make sure to develop and manage the best strategies for protecting the trade secrets while this information is still confidential.

This chapter will provide guidance for determining the scope of confidential information and trade secrets found in the franchised business, the challenges and risks associated with the development and use of that information, and how to effectively protect confidential and trade secret information from disclosure. Generally speaking, franchisors endeavour to protect their confidential information and trade secrets through provisions commonly contained in the franchise agreement and through the use of separate confidentiality agreements. This chapter will discuss these and other methods a franchisor can use to implement and maintain reasonable and responsible security measures to protect these vital assets.

Required disclosure of trade secrets to franchisees

Under the Federal Trade Commission's Franchise Rule,[2] a prospective franchisee in the United States must receive a franchise disclosure document (FDD) at least 14 days before signing a franchise agreement or paying any money to a franchisor. The FDD includes required disclosures on a variety of items and is intended to provide a potential franchisee with sufficient information to make an educated decision on whether or not to invest in the franchise opportunity.

In Items 13 and 14 of the FDD, the franchisor must disclose the nature of the intellectual property that the franchisor owns and licenses to its franchisees. This must include disclosures of legal disputes over the franchisor's intellectual property rights, rulings of government agencies and third-party agreements affecting the company's intellectual property rights. It should also include a discussion of the respective rights and obligations of the franchisor and the franchisee under the franchise agreement with respect to the intellectual property that is the foundation of the franchised business.

Item 14 of the FDD specifically deals with patents, copyrights and proprietary information. 'Proprietary information' in Item 14 of the FDD refers to trade secrets and other confidential information and includes any information the company protects against disclosure and that adds commercial value to the company. In this section of the FDD, virtually every franchisor references its confidential operations manual as containing the processes and methods that constitute the 'secret sauce' of the franchise system.

2 16 CFR Parts 436 and 437, Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities; Final Rule (2007).

Scope of confidential information and trade secrets

Confidential and trade secret information in the franchise industry can include a variety of information. Trade secrets are a subset of confidential information. They are items of confidential information that are deemed to have specific commercial value because the information is being kept secret.

A franchisor seeking to enforce a confidentiality non-disclosure provision or to enforce a statute protecting trade secrets will first be required to establish the scope of the information that is secret and whether the franchisor sufficiently identified the information and established its intent that the information be protected and treated as confidential.

There are many types of information that could be trade secrets in a franchise context, including, but not limited to, customer lists, financial information, marketing and sales information, distribution techniques, recipes, business formats, business plans, operations manuals, pricing techniques, profit margins, margin formulas and specially designed software.

Identification of trade secrets

As you will see below, there are laws in the United States and other countries that provide a variety of definitions of 'trade secret'. Those statutes and laws, as well as case law and decisions interpreting them, should be reviewed carefully as the franchisor embarks on the critical first step of protection: the careful and thorough identification of trade secrets. Along with identifying the trade secret, the franchisor must also be able to document the trade secret if it wishes to effectively protect it.

If a franchisor has not already created a database of its trade secrets, it should gather key executives to inventory trade secrets. Depending on the age and size of the business, this effort may require organisation among business unit management. It is important to have closed meetings among these stakeholders to discuss, debate and determine the information that is to be considered a trade secret by the franchise.

Trade secret categorisation may resemble a list, chart or database. There will be multiple categories of information and one or more specific type of information for each category. Categories of information to consider include technical and scientific, software and source code, manufacturing, product, processes, procedures, legal, human resources, marketing, sales, customer, financial, forecasts, results of consulting projects, and compilations of information.

It is the franchisor's job, with help from external advisers as needed, to determine and inventory the information that falls into each category. For example, the process information category may include a distribution method or a business model that is dependent on the application of a process that the franchisor considers to be a trade secret. Under the financial information category, trade secrets might include the method for determining pricing to ensure a profit. Marketing information may include customer lists or, if the customer lists are deemed to be too public to be protectable, it may include compilations of customer information such as customer habits or purchasing trends.

In the end, the process of identifying trade secrets should make it easier to manage and monitor the protection of that vitally important intellectual property. It will also provide clarity for assessing vulnerability of the trade secret and methods for protection, which is key to ensuring that the trade secret retains value.

As the franchisor develops and innovates, it will create and acquire additional trade secrets. It is critical to maintain an annual process of reviewing and identifying information so that it is maintaining a complete inventory of these valuable property rights.

Maintaining secrecy of trade secrets

The key question that arises in the litigation over the loss of trade secret information is whether the franchisor made reasonable efforts to maintain the secrecy of the information. To assess the best strategy and methods for protecting the information, it is first vital to assess vulnerability and risk. Whether a franchise operates in a few states or on a global platform, there are many exposures to be evaluated. Vulnerabilities to be assessed include internal and external threats, franchisee-related threats, competitive threats, organised crime, and even national and foreign intelligence threats.

It is also important to evaluate the value of the catalogued trade secrets and the potential economic impact of a loss; and to identify the development processes of each trade secret and determine what went into development of the trade secret in terms of time, costs and human resources.

Effective protection of trade secrets for franchisors

Once trade secrets are effectively inventoried, there are several methods that must be evaluated by the franchisor in developing an effective trade secret protection strategy. These methods should be evaluated as a whole, as well as for each independent trade secret.

As described herein, nearly all tribunals in the United States and internationally require that reasonable steps be undertaken to identify and protect information before such information will be classified legally as a trade secret. Failing to establish reasonable protections is usually fatal to a trade secret protection claim.

Proving reasonable protection can be difficult in a franchise context since the franchisor typically transfers much of the information relevant to the way it does business to a franchisee. This makes the franchisor's proprietary information vulnerable. If not protected sufficiently, a franchisee, its employees or a third party could copy products or information and start a competing product or business. Technology advances have increased the speed and ease of transferring information, and the increased mobility of employees raises risks in the franchise context.

Effective protection starts internally with the franchisor's own employees and continues through using disclosures, established clauses in the franchise agreement and regular audits. It can be difficult to prove to a court, arbitrator or tribunal that information is worthy of protection unless the franchisor has taken steps to identify and protect the information itself. The remainder of this chapter primarily focuses on the protections a franchisor should consider implementing in its relationship with a franchisee to attempt to ensure the franchisee's compliance with the franchisor's security strategy. Many of these methods can also be used by the franchisor internally.

The categories of security measures to be evaluated include items to be included in the franchise agreement and methods for carrying out a well-planned security strategy. Items to be discussed include the use of the operations manual and required employee policies and procedures, maintaining records, ensuring the inclusion of restrictive covenants in employment agreements between the franchisee and its key employees, training, establishing effective internal and external security systems, monitoring compliance, and engaging in regular audits and improvements.

Pre-contractual discussions

Before engaging in any discussions with a franchisee, a potential supplier or a third-party business partner, the savvy franchisor will request that the third party sign a non-disclosure agreement. Further, it is wise to conduct due diligence on the third party before disclosing sensitive information to evaluate any potential risks. The franchisor should also consider engaging in discussions at the outset of the relationship about the franchisor's expectations that the third party will comply with efforts to protect trade secrets and confidential information.

Franchise agreements

A franchise agreement includes a licence granting use of intellectual property, including trade secrets, to the franchise and contains extensive quality control and other requirements regarding the manner in which the franchisee must conduct its business. It is common and imperative to include requirements that the franchisee shall not disclose these trade secrets, not use them outside the approved and agreed uses, and take adequate precautions to protect the franchisor's confidential information from theft by third parties. The agreement should stress the importance of maintaining secrecy of the system's confidential information and trade secrets. This can be done in a variety of ways.

Identification of confidential information and trade secrets

The franchisor should identify its confidential information and trade secrets that are being provided to the franchisee and state that these items are being licensed to the franchisee as opposed to being sold. The franchisor's trade secrets should be broadly defined in the franchise agreement.

Negative and restrictive covenants

The franchisee should be bound by negative and restrictive covenants from competing with the franchisor during, and for a period of time after the termination of, the franchise agreement. The franchisee should also be prevented from divulging any confidential information, trade secrets and know-how during and after the termination of the franchise relationship.

The franchisee should also agree to enter into employment agreements containing restrictive covenants with all its employees who have access to the franchisor's confidential information, trade secrets and operating manuals. The franchisor should strongly consider whether to reserve the right to designate which of the franchisee employees will be required to execute agreements containing confidentiality agreements and restrictive covenants. The franchisor should also consider providing a form agreement for franchisees to use.

Recommended franchisee acknowledgements

The franchisee should be asked to acknowledge the existence and ownership of trade secrets. These acknowledgements should include, at a minimum, that: the franchisor is the owner of all proprietary rights in and to the system and operating manuals and to any changes or supplements to the system and manuals; all of the information contained in the operating manuals is proprietary and confidential (and belongs to the franchisor); the franchisee shall use its best or all reasonable efforts to maintain the secrecy of all confidential and trade secret information; the franchisee and its employees will have access to the franchisor's trade secrets; and the franchisor's trade secrets have substantial value that provides the franchisor and franchisee with a competitive advantage.

Internal protocol requirements

Franchisees should agree to implement internal protocols to ensure reasonable protections against the loss of trade secrets through theft by employees. These internal protocols may include employment policies and procedures, training, confidentiality agreements, non-compete agreements, security procedures (for paper documents, tangible material and electronic information), and conducting exit interviews. Franchisees should be asked to agree to strictly limit access to the operating manuals to those key employees who have a demonstrable and valid need to know the information contained therein to perform their position. The franchisees should also be asked to strictly follow any provisions in the manuals regarding the care, storage and use of the manuals and all related proprietary information.

Restrict unauthorised access and use

The franchise agreement should include a covenant that the franchisee will not reverse engineer, decompile or disassemble any items that are considered the trade secrets of the franchisor and that its employees will also acknowledge the same agreement. The franchisor should also include provisions in the agreement that restrict unauthorised use and disclosure of the system's trade secrets. It is also important to prohibit the franchisee and its employees from publishing any articles or press releases pertaining to the franchise or its activities until they are first reviewed and approved by the franchisor.

Post-termination of franchise agreement

Additional clauses should be considered to ensure that confidential and trade-secret information is kept privileged during and post-termination of the agreement. At the termination of the relationship, regardless of the reason for the termination, the franchisee must be contractually required to immediately return the information identified by the franchisor as its confidential, proprietary and trade secret information. This should include its operations manuals and any correspondence or other documents embodying or discussing trade secrets. The post-termination obligations may also require the franchisee to sign an acknowledgement that the franchisee and its employees do not have any ownership interest in the trade secrets, the manuals, or any items discussing or containing confidential information or trade secrets.

Policies and procedures

The franchisor should carefully draft and include specific guidelines in its operating manuals to guide the policies and procedures of the franchisee in protecting the secrecy of the franchisor's trade secrets. Aspects of the manuals may include: limiting access to the trade secrets to only those franchise employees that have a need to know for the performance of their duties; requiring locking of all offices, file cabinets or storage rooms in which confidential information may be found; limiting access to copying and scanning equipment and computers; password-protecting all computers; and encrypting all electronic communications containing references to the trade secrets. The manuals should also include policies for protecting trade secrets externally with third parties such as suppliers. Franchisors should also consider requiring the franchisees to maintain records to document its compliance with these policies and procedures.

Maintaining records

Policies should also be developed and implemented regarding marking, segregating, storing and disposing of documents, information and electronic equipment that contain confidential information and trade secrets. The franchisor should endeavour to mark as confidential all proprietary and trade secret information contained in documents and correspondence.

An example of marking a whole document as confidential can be as simple as marking the document 'confidential' or 'highly confidential'. Another method is to make the document in this way and also provide the following, or similar, instruction:

> *This document contains confidential and proprietary information of [Company] and is protected by copyright, trade secret, and other state and federal laws. The receipt or possession of this document by you does not convey any rights to you over the contents and you are strictly prohibited from reproducing, disclosing its contents, or manufacturing, using or selling anything described herein. Reproduction, disclosure, or use without specific written authorization of [Company] is strictly forbidden.*

The franchisee should agree that it will not at any time, without the franchisor's prior written consent, copy, duplicate, record or otherwise reproduce in any manner any part of the manuals, updates, supplements or related materials, in whole or in part, or otherwise make the same available to any unauthorised person.

There should be included in the franchise agreement a clause that ensures the operating manuals remain the sole property of the franchisor at all times. The franchisee should agree that it shall return all documents to the franchisor, including the manuals and all supplements, upon the expiration or termination (for any reason) of the franchise agreement.

Employee restrictive covenants and handbooks

The franchisor should consider requiring its franchisees to have every employee given access to the franchisor's trade secrets execute an employment agreement containing non-disclosure provisions, restrictive covenants and notice requirements of subsequent employment. As a best practice, the franchisor should endeavour to make certain its franchisees require that their employees execute agreements with such restrictive covenants and sign acknowledgements of receipt of employee handbooks, which should include the expected security measures regarding trade secrets and other confidential information.

The franchisor should make routine requests of all franchisees to provide copies of its employee lists and copies of their employees' executed employment agreements and handbook acknowledgements. During quality assessment visits, the franchisor should make a list of the employees who appear to have access to proprietary information. If an employee has access to confidential trade secret information but the franchisee does not have the required restrictions on such employee, the franchisee should be warned and the franchisor should ensure that the franchisee comes into compliance.

Training

Franchisors should endeavour to educate their employees and franchisees through training. Franchisees should be trained to understand the scope of information that the franchisor considers to be trade secret and on the required protection for each trade secret. A franchisor should consider creating a checklist for franchisees of required protections, monitoring and assessments. Regular and routine assessments could then be made using the checklist. Completed checklists should then be returned to the franchisor. Franchisees should be trained in the importance of limiting access to the operation manual. Protecting the brand means protecting their investment too.

Additional training should also be considered for franchisee employees. For example, the franchise could request the franchisee agree to, and then does, conduct periodic meetings with the franchise employees to instruct them as to their responsibilities to maintain secrecy of the franchisor's trade secrets. The franchisee could also be asked to conduct exit interviews with terminating employees and have them acknowledge in writing their post-employment obligations to the franchise.

Physical security systems

Internal security should also be implemented at the franchisor and franchisee offices. These measures could include maintaining documents detailing trade secrets under lock and key. Computers should be locked down so that they revert to a password-protected screen within a short and set amount of time. Registration should be maintained at a reception area with visitor logs or escorts. For entry into and out of restricted areas, visitors should be escorted and badges provided. Signage could also be implemented so that there are 'keep out' and 'authorised personnel only' signs used to mark areas as appropriate. Photocopiers and scanners should also be controlled access, including use of identification numbers or employee numbers to ensure the ability to trace unauthorised printing and shredding. For some information, it may even be necessary to store documents or other materials in a locked vault.

Monitoring

During regular franchisee quality-control visits, franchisors should consider including a review of trade secret protection and security compliance. Franchisors should also review advertising and promotional materials and press releases to protect trade secrets, and attempt to monitor trade press and business journals for any news indicating a possible compromise or exploitation of confidential information and trade secrets by others. It could also be important to police the activities of suppliers, franchisees and employees of both to ensure that there has been no disclosure or use of trade secrets. It may be important to require franchisees to include post-termination obligations in employment agreements that impose a duty on the employees who had access to trade secrets to keep his or her former employer aware of his or her whereabouts for a period of time after employment.

Regular audits and improvements

Regularly, on a planned basis, the franchisor should audit its security measures and compliance with those measures both internally and by franchisees. Compliance by franchisees with their contractual obligations regarding trade secret protection should also be monitored on a regular basis. Improvements should be made where there are weaknesses discovered or where security measures should be changed.

Statutory protections of trade secrets in the United States

In the United States, the concept of a trade secret is based on property rights. Theft of certain trade secrets is punishable under various federal criminal laws. Misappropriation of trade secrets is also actionable by private litigants through the civil legal process owing to relatively new federal and state laws in the United States that provide litigants with private causes of action.

The Economic Espionage Act

The Economic Espionage Act of 1996 is codified at 18 USC section 1839. It defines trade secrets as:

> *[a]ll forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, programmed devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing.*[3]

The Economic Espionage Act criminalises the theft of trade secrets and any conspiracies to acquire trade secrets with the knowledge or intent that the information would benefit a foreign power. If convicted, an individual faces potential fines of up to US$500,000 per offence and imprisonment of up to 15 years. Organisations convicted under this federal law can be fined up to US$10 million per offence.

The Theft of Trade Secrets Act

The Theft of Trade Secrets Act was codified in 1997 at 18 USC 1832 et seq. This federal law provides criminal penalties for trade secret misappropriation related to or included in a product that is produced for or placed in interstate or international commerce. The statute requires knowledge of or intent that the theft will harm the owner of the trade secret. The penalty is a fine of up to US$250,000 for individuals (up to US$5 million for corporations), imprisonment of up to 10 years, or both.[4]

The Defend the Trade Secrets Act

In 2016, the United States enacted the Defend the Trade Secrets Act of 2016 (DTSA).[5] This law is now codified at 18 USC 1836 and provides a civil cause of action for owners of trade secrets to pursue litigation in federal court when its trade secrets have been misappropriated.

The information qualifying as a trade secret under the DTSA is identical to that information deemed to be a trade secret under the Economic Espionage Act and the Theft of Trade Secrets Act. The definition itself is extremely broad, and includes information of any form, regardless of 'how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing', and of any type, 'financial, business, scientific, technical, economic, or engineering information', so long as: (1) the information is actually secret, because it is neither known to nor readily ascertainable by another person who can obtain economic value from the disclosure or

3 18 USC 1839(3).

4 18 USC section 1832.

5 Defend Trade Secrets Act of 2016, section 1890, 114th Cong (2016).

use of the information; (2) the owner has taken 'reasonable measures' to maintain the secrecy; and (3) independent economic value is derived from that secrecy.[6]

The DTSA provides a private litigant with a federal cause of action for trade secret misappropriation. Specifically, when a trade secret related to a product or service used in, or intended for use in, interstate or foreign commerce is misappropriated, the DTSA may be used to pursue injunctive relief and damages. Importantly, the DTSA allows companies to act quickly to prevent the dissemination of their trade secrets by giving federal courts the power to order a seizure of property on an ex parte basis. This provision is designed to prevent dissemination of trade secrets.

Before the enactment of the DTSA, trade secret owners could only pursue their claims of misappropriation in federal court if there was another statutory basis for federal jurisdiction. The DTSA provides federal courts with the ability to provide more uniform decisions on the issues of what is a trade secret and what are appropriate remedies for misappropriation.

The DTSA does not pre-empt existing state trade secret laws, so businesses still have the option to bring trade secret cases in state court under state law where they will, theoretically, obtain the benefit of a well-developed body of case precedent.

The Uniform Trade Secrets Act

In the United States, almost every state has adopted a version of the Uniform Trade Secrets Act (UTSA), which is deemed to pre-empt common law protections over confidential information. The only state that has not yet adopted a version of the UTSA, as at the time of writing, is New York.

Generally speaking, information that meets the definition of a trade secret in the applicable statute is intended to be considered and treated as a trade secret.

The UTSA defines a 'trade secret' as information, including a formula, pattern, compilation, program, device, method, technique or process, that:

- derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and
- is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.[7]

Both elements are important. The first – independent economic value from not being generally known – should appear naturally in most successful franchises. The second element – reasonable efforts to maintain secrecy – requires constant care and attention.

Notably, each state in the United States that has enacted a version of the UTSA applies the act's definition of trade secrets differently. Such differences can be slight, other differences can be significant. For example, in some states customer lists are presumptively trade secrets, while in others they are treated presumptively as not trade secrets.

Trade secrets lose their protection if they become generally known. Typically businesses employ measures such as restrictions on the disclosure of trade secrets to only certain key employees who truly have a need to know such information. As mentioned, businesses also use the security efforts outlined in this chapter, which include, but are not limited to, non-disclosure

6 18 USC section 1839(3).

7 UTSA section 1(4).

agreements, restrictive covenants and erecting physical barriers to prevent access to protect their trade secrets.

Under all versions of the UTSA, proving misappropriation of trade secrets can result in injunctions and, depending on the nature of the misappropriation, the return or destruction of the misappropriated material. If the misappropriation is proven to have caused damage, the victim can receive damages in a lump sum or potentially as a royalty. If the misappropriation was wilful (and most are), then the UTSA supports an award of double damages and attorneys' fees.

The enactment of these laws means that information that is not deemed a trade secret under the law, but may be otherwise deemed to be confidential information, is not legally protected. If a franchisor cannot prove that the allegedly stolen information rises to the level of a trade secret, as defined by the relevant statute, then the only means of protecting that information is through a contract. Therefore, it is imperative to obtain an agreement with those who are given access to sensitive information that they will not disclose that information and to ensure that the definition of confidential information used in such a non-disclosure agreement clearly covers the information at issue.

Franchising presents unique challenges in this regard as sharing and replicating trade secrets business to business is the cornerstone of the model. As discussed in detail in this chapter, confidentiality covenants, negative covenants, and inclusive and accurate definitions of confidential information, which fully capture and protect those aspects of the franchisor's system that derive independent economic value from not being readily ascertainable, are vital. The confidentiality requirements should also capture all third parties who may be associated with each franchisee and who may have access to such confidential information. This list could include suppliers and family members. Since trade secrets and confidential information may encompass some of the franchise's most valuable assets, care must be taken to ensure that appropriate measures are in place so that the confidential nature of such information will be upheld and enforced by the courts.

International trade secret protection laws

Trade secrets and confidential information are perhaps the most difficult forms of intellectual property to protect internationally. The common practice of using non-competition covenants to protect them is often counter to local policies on the use of such covenants.

There is no uniform legal theory internationally as to the basis for determining what is a trade secret or how it might be protected.[8] In some jurisdictions, such as Canada, trade secrets are based on relational obligations such as contract, employment status or fiduciary duty. Other countries base trade secret protection on fairness and equity, unfair competition law or tort. The effectiveness of trade secret protection varies primarily with the nature of the legal system in each country. There are many more civil law jurisdictions in the world than common law jurisdictions, and almost uniformly civil law jurisdictions do not have pretrial discovery or depositions, rendering the protection of trade secrets and confidential information more difficult. Generally

8 See, Schultz, M and D Lippoldt (2014), 'Approaches to Protection of Undisclosed Information (Trade Secrets): Background Paper', OECD Trade Policy Papers, No. 162, OECD Publishing, Paris, https://doi.org/10.1787/5jz9z43w0jnw-en.

speaking, civil law jurisdictions require written records that are carefully recorded and verified from the start of the transaction.

There are other areas where policy differences between jurisdictions lead to variations in the enforcement of the protection of trade secrets – for example, in the enforceability of non-disclosure agreements and restrictive covenants. Given this, franchisors are advised to maintain meticulous records and to start their system of international protection with franchise and other third-party agreements that are narrow and tailored to the target jurisdiction.

Appendix 1

About the Authors

Mary Goodrich Nix
Holland & Knight LLP

Mary Goodrich Nix is a partner at Holland & Knight and co-chair of the firm's trade secrets and restrictive covenants team. She manages complex commercial, employment and trade secret matters for publicly traded and privately held companies, including Fortune 500, middle market companies, and startups in a variety of industries. Ms Nix has experience in counselling clients on compliance with franchise registration, disclosure regulations and negotiating complex franchise transactions. In addition, she has extensive courtroom experience and has litigated and arbitrated numerous cases throughout Texas and in other parts of the country. Ms Nix is board certified in labor and employment law by the Texas Board of Legal Specialization.

Holland & Knight LLP
200 Crescent Court, Suite 1600
Dallas
Texas 75201
United States
Tel: +1 214 964 9407
Fax: +1 214 964 9501
mary.nix@hklaw.com
www.hklaw.com