

**IBA/IFA 27TH ANNUAL JOINT CONFERENCE**

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**NEW APPROACHES AND CHALLENGES IN INTERNATIONAL FRANCHISING**

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**PUERTO RICO: IS EVERY FRANCHISEE A DISTRIBUTOR?**

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**1. The Significance of Law 75**

Puerto Rico is one of the jurisdictions most protective of commerce intermediaries. That protection is statutory in nature and goes well beyond judicial protection of the contract as agreed to by the parties.

**1.1 Prohibited Actions**

The most important of Puerto Rico's statutes in this field, is the Puerto Rico Dealers Act commonly known as Law 75. Basically, Law 75 provides that once a distribution relationship is established, the principal cannot terminate, refuse to renew at its normal expiration the distribution agreement, nor can it undermine the contractual terms of the same, unless for just cause.

**1.2 Just Cause**

Just cause is not something that the parties can independently agree to. Just cause is defined in the statute as a breach by the distributor of an essential term of the agreement, or any act or omission on his part that seriously impairs the interests of the principal in the distribution of the product or service in Puerto Rico.

In other words, if a distribution relationship exists, the principal can terminate it, refuse to renew it at its normal expiration or change the contractual rights of the distributor only by mutual agreement with the distributor or by proving serious and damaging acts on his part. The interests of the principal, no matter how commercially sound, play no role in establishing just cause except when the principal is going to quit the market under certain conditions or sell its assets.

**1.3 Damages and Injunction**

Clearly, Law 75 is a one-way-street in favor of the distributor. If the distributor is in a position to allege that Law 75 has been breached, it may avail itself of the statutory injunction that Law 75 has and it can also request the payment of damages. Those damages are essentially calculated pursuant to a formula contained in the law itself. Of the four factors in the damages formula, the two most important ones are the payment by the principal of the goodwill lost by the distributor and a compensation equal to five years of benefit. The distributor may also claim any other damages arising out of the breach by the principal of Law 75. The law also provides for a preliminary injunction of statutory character.

**1.4 Law 75's Public Policy**

Law 75 is imbued with a strong public policy. Its provisions cannot be waived by the distributor, a Law 75 case cannot be litigated outside of Puerto Rico and a covenant to apply to the contract a law other than the law of Puerto Rico is voided by Law 75. The only way to prevent the application of Law 75 is by including in the contract an arbitration clause with a choice of foreign law provision. The preemptive effect of the Federal Arbitration Act, obligates courts in Puerto Rico to order arbitration under the conditions adopted by the parties.

## **2. What is Distribution?**

Of course, for Law 75 to apply a distribution relationship has to exist. For many years, practically all intermediaries of commerce sought protection under Law 75. In 1988, the Supreme Court recognized that intermediaries such as a sales agent that keeps no inventory and simply places orders for the principal on a commission basis, is not a distributor protected by Law 75. This 1988 decision prompted the Legislative Assembly of Puerto Rico to approve Law 21, essentially giving sales representatives a protection similar to the one granted by Law 75 to distributors.

## **3. The Franchise Contract and Law 75**

Similarly, for many years the consensus has been that franchisees are distributors protected by Law 75. That assumption was placed recently in doubt by the case of *Franquicias Martin's BBQ vs. García de Gracia*, 2010 TSPR71, 178 D.P.R., decided in the year 2010. The court described therein a typical food franchise and concluded that said type of contract was an atypical contract, that is, not subject to special statutory regulation but to the will of the parties. In a footnote, the court says that a franchisee will be covered by Law 75 only if it fits the uncertain definition of a distributor under said act.

The 1988 decision that made the distinction between distributors and sales representatives, described the distributor protected by Law 75 as someone who buys a product for resale purposes, creates a market for the same, keeps inventory of the product, prices the same independently, runs credit risks, and other similar factors. The list of factors is not exclusive and the decision has to be made on a case to case basis.

Even after *Franquicias* many people believe those elements are met by a franchisee. I do not. A typical franchisee buys nothing from its principal other than a business model. It acquires from the principal no product for re-sale. Contrary to a distributor it does not operate under its own name and also contrary to the distributor it is strictly subordinated to the principal in its mode of operation. In short, if simply selling the product under the principal's brand, charging for it, pricing it independently, etc. were enough to turn a franchisee into a distributor, all franchisees in Puerto Rico would be distributors and the independent franchise contract recognized recently by the Supreme Court would not exist.

To my mind, the legal nature of a distribution and a franchising contract is quite different. Of course, there are overlapping elements. But, if we go beyond those common elements, the distinctions arise clearly. I believe that the franchisee is a commerce intermediary not contemplated by Law 75.

Right now, this controversy is before the courts of Puerto Rico and eventually will be decided by the Puerto Rico Supreme Court. There are still many that believe that a franchisee is nothing but a distributor.

## **4. What to do in Puerto Rico**

While this is decided, the Legislative Assembly has before it two legislative bills promoted by franchisees to make sure that they get a protection similar or even greater than that given to distributors under Law 75. See S. Bill #1872 of October 18, 2010 and HR. Bill #3059 of November 9, 2010. Although the bills do not seem close to approval, a close watch should be kept over the same by anyone contemplating franchising business in Puerto Rico. It is clear that the impairment of contract's clause prevents the retroactive application of any new franchise law to existing franchisees, but any franchisor contemplating granting new franchise agreements in Puerto Rico will be better off by including in those contracts a mandatory arbitration clause with a choice of law other than the law of Puerto Rico.