ENTERING THE U.S. FRANCHISE MARKET: A SUMMARY OF LEGAL CONSIDERATIONS

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Franchisors that have developed successful programs in their home countries will frequently consider expansion opportunities in other countries. In the past, the United States was not necessarily an attractive venue in light of the high degree of regulation of franchising. Increasingly, other countries have adopted laws governing the offer and sale of franchises and businesses and their counsel have become more comfortable navigating through disclosure and registration requirements. This article describes some of the steps a franchisor must take in preparing to enter the U.S. market, complying with U.S. franchise laws and managing the issues that will typically arise in the process.

Overview of U.S. franchise laws

Franchising in the U.S. is regulated under federal law and, in some cases, state law. Unless a transaction is exempt, pre-sale disclosure is mandatory.

The Federal Trade Commission (“FTC”) has adopted a Rule on Disclosure Requirements and Prohibitions Concerning Franchising (“FTC Rule”). The FTC Rule requires that pre-sale disclosure be provided to prospective franchisees in the United States and its territories. A franchisor must provide a prospective franchisee with this disclosure document at least 14 calendar days before the franchisor receives any consideration from the franchisee or the parties sign a binding agreement. The FTC Rule does not require that a franchisor file this document or obtain a registration.

There are 23 categories of information that must be included in the disclosure document required under the FTC Rule:

− Item 1: The Franchisor and Any Parents, Predecessors and Affiliates – This Item requires disclosure about the franchisor and certain related companies, the history of their operations, the franchise being offered, competition and regulations that affect the operation of the franchised business.

− Item 2: Business Experiences – Required are five-year employment histories of the individuals with senior positions and management responsibility with the franchisor.

− Item 3: Litigation – Selected pending and concluded litigation involving the franchisor, certain of its affiliates and the individuals listed in Item 2 must be included.
Item 4: Bankruptcy – Similarly, information on any bankruptcy involving these parties during the previous 10 years must be disclosed, even if unrelated to the franchised business.

Item 5: Initial Fees – These are fees payable to the franchisor or its affiliate before the franchise opens for business.

Item 6: Other Fee – These are other fees the franchisee must pay to the franchisor or its affiliate, and includes payments the franchisor collects for a third party.

Item 7: Estimated Initial Investment – A range of initial expenses a franchisee will have to make must be included, along with an estimate of additional funds the franchisee will have to spend during the initial period of operations (minimum of three months).

Item 8: Restrictions on Sources of Products and Services – The required information includes disclosure of products and services for which the franchisor establishes specifications, approved or designated suppliers, or which it provides itself. Revenues and other benefits the franchisor receives must be disclosed.

Item 9: Franchisee’s Obligations – This is a chart that cross references provisions in the disclosure document and in the franchise agreement.

Item 10: Financing – If the franchisor finances a portion of the franchisee’s obligations or arranges for financing by a third party, details of the arrangement must be disclosed.

Item 11: Franchisor’s Assistance, Advertising Computer Systems and Training – This Item must include details and franchise agreement provision references for all of the franchisor’s pre-opening obligations as well as its obligations when the franchised business is operating.

Item 12: Territory – Details must include information about the territorial protection provided to the franchisee, how the territory is determined and activities using alternate channels of distribution.

Item 13: Trademarks – The franchisor must disclose trademark registration information, any infringing uses, and how the franchisor will protect its trademarks and the franchisee’s right to use them.

Item 14: Patents, Copyrights and Proprietary Information – This Item must include registration information about any patents and copyrights germane to the franchised business, how the franchisor will protect them and the franchisee’s right to use them, as well as listing categories of information that are proprietary to the franchisor.

Item 15: Obligation to Participate in the Actual Operation of the Franchise Business – Details required in this Item include whether the franchisee may employ a manager to oversee the business.

Item 16: Restrictions on What the Franchisee’s May Sell – Any restrictions on the franchisee’s operations including what the franchisee must sell and what the franchisee is limited to selling must be disclosed.

Item 17: Renewal, Termination, Transfer and Dispute Resolution – This Item is a chart with cross-references to the franchise agreement and disclosure document and summaries of the duration, renewal, transfer, termination and dispute resolution terms of the franchise.

Item 18: Public Figures – Information about any public figures endorsing the franchise must be disclosed.

Item 19: Financial Performance Representations – In this Item the franchisor may include information about the actual or potential performance of its franchised or company-owned outlets if it has a reasonable basis for doing so. It is an optional disclosure.

Item 20: Outlet and Franchisee Information – There are five charts in this Item presenting various information about franchised and company-owned outlets for the last three years, as well as an estimate of outlets to be opened in the next year.
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- **Item 21: Financial Statements** – The franchisor’s audited financial statements for the past three fiscal years must be included.

- **Item 22: Contracts** – All contracts related to the franchise must be listed and attached as exhibits.

- **Item 23: Receipts** – The form of Receipt is mandated and all franchise sellers involved in the sales process with a specific franchisee must be included in the Receipt form delivered to that franchisee.

Fifteen states also regulate the offer and sale of franchises. They are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

These states all accept the disclosure format required by the FTC Rule. The FTC Rule specifically permits states to add to the disclosure document, and many have. Typically franchisors will attach a state-specific addendum to address these requirements. There is also a state cover page that must immediately follow the FTC-mandated cover page.

As noted above, the FTC Rule requires a 14 calendar day cooling off period before the prospective franchisee may pay consideration or sign a binding agreement. The FTC Rule does not pre-empt state laws that have more protective requirements. Currently, one state (Michigan) requires that disclosure be provided 10 business days before the payment of consideration or execution of an agreement, and two more states (New York and Rhode Island) add the requirement that disclosure be made at the first personal meeting of the parties to discuss the possible purchase of a franchise if that is earlier than the 10 business day period.

The FTC Rule has some additional disclosure requirements. If a prospective franchisee makes a reasonable request to receive the disclosure document earlier in the process, the franchisor is required to provide it. This allows a prospect to access the disclosure before making preliminary expenditures, such as travel expenses involved in visiting the franchisor’s offices for a discovery day.

If the franchisor makes a unilateral and material change to the franchise agreement, it must disclose that to the prospective franchisee at least seven calendar days before the parties sign the franchise agreement.

Fourteen of the fifteen states with franchise laws that address the offer and sale of franchises also require the registration of franchise offers. These registration processes range from a notice filing to a full examination of the proposed disclosure document and an analysis of whether or not it meets the requirements of the required disclosure format. Many states are required by statute to respond within a certain period of time after an application is filed, but frequently require a waiver of those provisions.

A number of states and territories also regulate the relationship between franchisors and franchisees. They are: Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Idaho, Illinois, Indiana, Iowa, Louisiana, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, North Dakota, Rhode Island, South Dakota, Virginia, Washington, Wisconsin, Puerto Rico and the Virgin Islands. These laws restrict a franchisor’s ability to terminate a franchise relationship and mandate good cause and notice requirements. They frequently allow a cure period after notice of default is sent by the franchisor. They also restrict the circumstances under which a franchisor can decide not to renew the franchise.

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Franchise relationship laws occasionally regulate the right of a franchisee to associate with other franchisees, the location and governing law for dispute resolution, and competition by the franchisor. Several states also prohibit a franchisor from discriminating among franchisees.

Other laws affecting franchise systems

More than 20 states also have laws that address the offer and sale of business opportunities. These laws frequently exempt franchises from their coverage. Florida and Utah require an annual notice filing and fee payment to qualify for the exemption. Kentucky, Nebraska and Texas require a one-time filing. If a law’s business opportunity definition does not exclude franchises per se, a franchisor may still be able to avoid falling within the jurisdiction of the law based on the license of a registered trademark and the avoidance of certain representations in the sales process.

Non-U.S. franchisors entering the U.S. market must investigate and comply with anti-terrorism and similar laws, especially if they form a U.S. entity to conduct business in the United States. The United States Treasury Department implements various laws and measures for the purpose of enhancing national security through economic sanctions, addressing financial networks of terrorist organizations and safeguarding domestic financial institutions.

Any goods or materials exported to the United States will be subject to formal U.S. Customs entry procedures, including duty assessment. A key decision for foreign franchisors is the choice of person or entity to act as “U.S. importer of record” in connection with imports into the U.S. The importer of record is the party responsible to U.S. Customs for the payment of duties and compliance with all import restrictions and formalities. The foreign franchisor can do one of the following:

(i) establish a U.S. subsidiary for this purpose;
(ii) rely on an unrelated third party (such as its U.S. developer); or
(iii) act as a foreign importer of record itself, although this last alternative is not generally recommended.

In addition to U.S. Customs & Border Protection entry procedures, any items sent to the U.S. may be subject to product-specific regulation by a multitude of other federal and state agencies.

A non-U.S. franchisor will often send personnel to the United States for purposes of planning, training and inspection of franchised locations. Admission of foreign persons into the United States is governed by the U.S. immigration laws. Individual states have no authority to grant work visas.

Generally, a non-U.S. individual can be admitted into the United States under one of two broad categories – immigrant or non-immigrant. Immigrant status is appropriate for persons seeking to become permanent residents of the United States. Individuals with permanent residence have the right to live in the United States indefinitely and to pursue virtually any investment or business objective. Obtaining permanent residency status as an immigrant is commonly referred to as obtaining a “green card.”

The number of foreign persons who can obtain immigrant status in any year is generally limited, and there are preferences that favor relatives of U.S. citizens or individuals who possess unique skills that are difficult to find among U.S. workers.

The majority of non-U.S. citizens who enter the United States do so through non-immigrant visas. A non-immigrant visa allows a foreign person to reside temporarily in the United States for a given period of time and, depending upon the particular visa classification, to engage in specific permitted activities. For example, EB-5 visa programs have become increasingly popular in franchising.
Preliminary steps to entering the U.S. market

Protection of intellectual property is a necessary early step in the decisions of non-U.S. entrepreneurs who want to enter the U.S. market. Companies should explore the following types of protection for their goods and services. They should also check on whether their home countries are parties to any Conventions that might accord additional rights and priorities in the registration process.

**Trademarks** – These rights originate from commercial use of distinctive words, names, symbols and logotypes that distinguish the source of goods or services. They can include colors, shapes, sounds and even smells. Parties can register trademarks with the United States Patent and Trademark Office (USPTO) based on either actual use or intent to use. Once a registration issues, the owner will have increased benefits including a nationwide presumption of priority as of the filing date.

**Patents** – Patent protection is also granted through the USPTO. There are three types of patents. Utility patents protect the functional features of a process, method, machine, manufactured, item or composition of matter if the feature is new, useful and nonobvious. Design patents protect non-functional, visual uniqueness. Plant patents grant rights to exclude others from asexually reproducing man-made plants.

**Copyrights** – This protection is accorded original expressions of ideas and information in tangible forms such as books, music, pictures, sculpture, motion pictures and other artistic works. U.S. federal copyright law automatically protects rights to copyrights once the work is created and it is in a tangible medium of expression. Registration with the U.S. Copyright Office can afford additional rights to the owner of a copyright.

**Trade Secrets** – Trade secrets are protected by state law. Generally, state law defines a trade secret as information such as a formula, recipe, compilation, program, device or process that has value because it is not readily ascertainable by another person.

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**Domain Names** – The U.S. has adopted the Anticybersquatting Consumer Protection Act to allow a party to recover a domain name that incorporates its trademark and to seek monetary damages. There are other strategies that may be advisable to protect against third party use of trademarks including adopting a defensive domain name registration strategy.

In addition to protecting intellectual property rights, there are other preliminary considerations a non-U.S. franchisor should evaluate. For example, local sourcing of fixtures and equipment will be a major factor. The look and feel of the franchised business, sometimes referred to as “trade dress”, is often an integral part of the franchise system.

Decisions on product sourcing are also crucial. For example, a franchisor may be perfectly willing to source non-proprietary products and recipes locally in the U.S. Divulging its secret recipes or formulas for proprietary products may be a different matter.

Depending on the franchisor’s home country, there are also issues related to converting units and measures and translation of written materials such as operations manuals and training and advertising materials.

Finally, if the franchise involves anything that might reflect local taste such as food and beverage franchises, a non-U.S. business person would be well advised to conduct market feasibility testing to make sure that the products will be suitable to American taste.

Depending on the manner in which the non-U.S. franchisor decides to enter the U.S. market, some of
these steps can be taken in cooperation with a U.S. master franchisee or area developer.

Finally, non-U.S. franchisors should have their local and U.S. tax and corporate advisors consult together on the choice of an entity to conduct franchise operations in the United States. That decision will be driven by a number of considerations, including tax and accounting issues as well as issues related to the franchisor’s disclosure obligations under U.S. franchise laws.

**Designing the U.S. franchise operations**

There are many variations to the possible structure of a franchise program in the United States.

Unit franchising, sometimes referred to as direct franchising, means a franchise in which the franchisor grants the franchisee the right to operate a single business under the franchisor’s name and system. The parties sign an agreement that is usually referred to as a franchise agreement. This type of franchise structure will accord the non-U.S. franchisor the greatest amount of control over the U.S. system, but will also require local presence and greater investment by the franchisor.

Area development programs involve the grant of the right to operate a number of unit franchises to a single developer. These arrangements grant a territory to the developer, along with exclusive rights to develop the unit businesses so long as the developer complies with the terms of its agreements with the franchisor, including a development schedule. The developer enters into separate franchise agreements for each new location, although occasionally a franchisor will grant unit rights in the area development agreement itself. The developer does not have the right to grant any of these rights to develop unit franchises to others.

In a master franchise program (sometimes referenced to as a subfranchise program), the master franchisee has the right to develop a territory and to grant unit franchises to subfranchisees. The master franchisee may also have the right to develop units itself. Some master franchise programs are hybrids that require that the master franchisee must develop a certain number of unit franchises before being able to subfranchise rights to third parties. One cautionary note – a subfranchise program will involve disclosure to prospective franchisees in the U.S. that includes information about both the master franchisee and the franchisor. It involves potential liability for both parties.

Development agents (sometimes referred to as area representatives) solicit candidates for a franchisor that meet the franchisor’s qualifications for prospective franchisees. They also provide some or all of the services that the franchisor is required to provide to the franchisee under the franchise agreement. These may include training, quality assurance control, advertising support and product and service supplier information.

**Special concerns for inbound international franchise systems**

A non-U.S. franchisor must consider many tax and accounting issues in entering the U.S. market. Of special concern is Section 482 of the Internal Revenue Code. This section provides that the Internal Revenue Service may reallocate gross income, deductions, credits or allowances between or among organizations, trades or businesses that are under common control if such reallocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses. It behooves a franchisor to set prices on arrangements between the franchisor and its affiliates on an “arms-length” basis for licenses and other types of agreements. Otherwise, the Internal Revenue Service may
reallocate items for tax purposes if it finds that commonly controlled organizations are entering into pricing or allocation arrangements that are designed to minimize taxes to the organizations on a collective basis.

Another issue related to the non-U.S. franchisor’s financial statements. While all non-exempt franchisors in the U.S. are required to include audited financial statements in their disclosure documents, there are some specific issues that affect non-U.S. franchisors. The FTC Rule requires that the financial statements be prepared according to U.S. generally accepted accounting principles (GAAP) as revised by any future U.S. mandated accounting principles or as permitted by the U.S. Securities and Exchange Commission (SEC). The financial statements must be audited by an independent certified public accountant (CPA) using generally accepted U.S. auditing standards (GAAS). Non-U.S. franchisors that do not form a U.S. affiliate to conduct the franchise program may face the issue of whether or not their CPA and audited financial statements meet these standards. It is possible to address this issue by preparing reconciliation between the standards under which the franchisor’s financial statements were audited and GAAS, but this can cause delays if the franchisor has not already considered this issue early in the planning process.

Closely related to the issue of financial information is the concern that a state franchise examiner may impose what is known as a financial assurance condition on the non-U.S. franchisor’s registration. This is not an exclusively international issue. U.S. franchisors also face this issue, especially when they first begin franchising. Most of the laws adopted by states that regulate the offer and sale of franchises accord examiners the power to address situations in which they are concerned with the ability of a franchisor to provide services promised to franchisees to get them up and running. Examiners are devoting increased scrutiny to franchisors’ financial conditions, especially in light of the recent economic recession. State laws permit examiners to impose a requirement that the franchisor escrow initial fees paid by the franchisee until the franchisee opens for business. There are often alternatives available to a franchisor applicants that include:

(i) posting a surety bond;
(ii) obtaining the guaranty of a parent or affiliate corporation;
(iii) deferral of payment of initial fees by the franchisee until all pre-opening services have been provided by the franchisor;
(iv) an additional capital infusion; and
(v) a loan by a principal or affiliate of the franchisor with an agreement not to require repayment for a certain amount of time.

In some states, examiners will also require the addition of a risk factor.

In addition to financial and accounting issues, there are some disclosure issues to address as well. As noted above, making disclosure about the actual or potential performance of the franchise (known as a financial performance representation or FPR) is not a required disclosure. It is optional. Nonetheless, it is often desirable to provide this type of information to prospective franchisees because it allows the franchisor and its representatives to discuss the substance of the representation with prospective franchisees.
The FTC Rule and state law require that a franchisor have a reasonable basis and written substantiation for any financial performance representation it makes. An issue can arise for a non-U.S. franchisor because when it enters the U.S. market it does not have franchisees in the United States and, therefore, cannot base its financial performance representation upon U.S. franchisees’ historical results. If the franchisor is a newly-formed U.S. entity, it will not yet have any financial results based on its own company operations. Does a non-U.S. franchisor have a reasonable basis for presenting non-U.S. financial performance information to U.S. prospective franchisees?

The FTC staff has not addressed this issue directly. It has opined on whether the financial experience of the franchisor’s affiliate can form the basis of a financial performance representation. Under limited circumstances, it is permissible if the franchisor does not have any operating history and the affiliate’s operations are substantially similar to those of the franchised business being offered. Whether the affiliate’s franchisees outside of the United States could provide the data for a financial performance representation is an open question. It may be permissible, depending on whether the operations in the franchisor’s native country are substantially similar to those planned in the United States. But the structure and operation of franchises in the United States may vary from their non-U.S. counterparts due to local taste, differences in suppliers and language. Therefore, whether there is a reasonable basis for using these numbers to present a financial performance representation in the United States should be analyzed on a case-by-case basis.

In conclusion, a successful entry for a non-U.S. franchise program in the U.S. market takes advance planning and anticipation of issues that can drain time and resources if not addressed early. Adopting and executing a strategy that makes sense for the long term growth of the franchise system in the United States will then be easier to achieve.

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