

TAKING THE LEAP: BRINGING A FOREIGN BRAND TO THE UNITED STATES

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Increasingly, franchise concepts that begin in one country soon find that expansion involves not only domestic growth, but also development in other jurisdictions including the United States. Over the past decade, advances in electronic communication have made this type of expansion even easier. This article's focus is on the challenges a non-U.S. franchisor will face in entering the U.S. market. The authors consider it an interesting exercise to address 20 questions that any non-U.S. franchisor will have as it considers taking the leap and bringing its brand to the U.S. Some of these questions tackle a mix of business and legal considerations; others are primarily focused on legal concerns. The answers reflect the experiences of foreign counsel who has assisted local clients in entering the U.S. market, U.S. counsel who have advised foreign clients interested in the U.S. market, as well as in-house counsel who has worked to bring an acquired foreign brand into the U.S.

* This article was originally prepared as a paper given at the Annual Conference of the International Bar Association in Boston, October 2013.

* For a more extensive review of many of the issues considered in this paper, see Susan Grueneberg, "In-bound Transactions: Introducing a Non-U.S. Franchise Program to the United States" in FUNDAMENTALS OF INTERNATIONAL FRANCHISING (W. Woods ed., ABA Forum on Franchising, 2d ed, 2013) (2001).

1. Most “foreign brands” that want to enter the U.S. are probably not taking this step (leap) as the first step. We will assume that the foreign brand is franchised in its home country and that the franchisor has already exported its system to other countries, closer to home. Does the franchisor take the same approach when expanding to the U.S. as it did when going into its neighboring countries?

For many non-U.S. franchisors, a presence in the U.S. is a desirable goal. However, it is also a giant leap for most. You leave your familiar environment, the culture you are accustomed to and you take your system far away, to a new continent. Is it just another small step for man or a giant leap for mankind?

Most franchise systems start locally and expand in a spiral-shaped pattern from their first location. They start in familiar neighborhood and expand unit by unit. As long as they expand within their home country, they can use the same franchise agreement, the same manual, the same training and probably the same approved suppliers. They can expand safely in a familiar manner.

However, when the franchisor reaches a natural boundary, a state line or a new country, it needs to stop and investigate if there will be any obstacles. The obstacles can be purely business related. Before establishing a business anywhere in the world, the franchisor should make sure that the business itself will work. Do the end-users in the target country appreciate the goods or services provided? Is there a market and is the market ready for the way the goods or the services are provided? In some countries, workers have a hot lunch sitting down in a restaurant. In other countries, the same workers bring a bag lunch or get a take-away sandwich for lunch. Some countries will have high labor costs which may make a personnel-intensive franchise system unprofitable.

Most franchisors choose to start their expansion abroad by establishing in a country that feels familiar or close to home. Beware: the country that

is geographically closest might not be the easiest or best for expansion. For example, from Sweden, Finland is one of the closest foreign territories. However, the Finnish language is totally different from Swedish and hardly any Swedes speak Finnish. The expanding franchisor would have an easier expansion into England when it comes to language barriers. An expanding franchisor should review information published by certain governmental authorities such as the U.S. Commercial Service, the trade promotion arm of the Department of Commerce, or similar types of entities in the franchisor’s home country. The relevant service should have commercial research and studies on which neighboring countries have the most similarities from a business and cultural perspective to the franchisor’s home country.

Only the franchisor that has already exported its system to another country should consider expanding to the U.S. Only after experiencing obstacles on a smaller scale will it be possible to survive an expansion to the U.S. Only armed with the attitude and willingness to adjust to another legal system and another cultural system and with an openness to new approaches along the way, will it even be worthwhile for a foreign franchisor to consider “taking the leap.”

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2. This is a common theme from foreign franchisors: “We’ve always done it our way. It works in every other country – Why won’t it work in the U.S.?”

Outside the U.S., there has been relatively little regulation around franchising. It has been easy to expand a franchise system to other countries and in most cases, there has not even been a reason to consider if what is expanded falls under the definition of franchising.

During the last 20 years many countries in the world have introduced disclosure laws. Due to this circumstance, franchisors have become aware that the definition of franchising may vary from country to country. Franchisors have become familiar with different rules in different countries and the fact that one has to produce different documentation when entering a new country. However, the variation of the information that needs to be disclosed is not that vast. When exporting to neighboring countries the variations may not even be noticeable. With good counsel the franchisor may even prepare a disclosure document that may be used in more than one jurisdiction. With that approach, it is easy to understand why a franchisor may ask: “It works in every other country – why won’t it work in the U.S.?”

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For any expansion into the U.S., the foreign franchisor must become acquainted with the federal disclosure law applicable to all franchises in the U.S. known as the Franchise Rule of the U.S. Federal Trade Commission (“FTC”)¹ and the requirements for a Franchise Disclosure Document (“FDD”) (See Question 14). A detailed step by step explanation of the contents of the FDD is beyond the scope of this paper, but a helpful discussion can be found in the U.S. chapter of the ABA Forum on Franchising book, *International Franchise Sales Laws*.²

In addition to disclosure regulations the foreign franchisor will encounter new fields of laws that even their home country counsel may not be aware of, like business opportunity laws and franchise relationship laws (See Questions 16 and 19). It can also be somewhat awkward when a foreign franchisor learns that it will now have to comply with U.S. anti-terrorism laws and laws on money-laundering (See Question 15). Even visa requirements will start a debate on whether or not to consider exporting the franchise system to the U.S.

3. Should the franchisor use master franchising or development agreements for the U.S. market? If so, how big a territory should the franchisor grant to the master franchisee or area developer?

When expanding a franchise system to the U.S. the franchisor has to choose the method for expansion. Establishing a subsidiary and beginning direct franchising is very time consuming and expensive. It will probably become the long-term focus of the franchisor which could be detrimental to the franchisor’s existing business. Instead, the

¹ The complete name of the FTC Rule is “Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures,” 16 C.F.R. §§ 436 and 437 (2007).

² John R. F. Baer and Susan Grueneberg, *United States of America*, in INTERNATIONAL FRANCHISE SALES LAWS (M. Lindsey and A. Loewinger eds, ABA Forum on Franchising, 2011 updates) (2006). See also David W. Oppenheim, “New disclosure protocol under the revised FTC franchise rule,” *International Journal of Franchising Law*, 2008/5-6, pp 37-41.

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franchisor may consider contracting with a local party in the U.S. – someone who is familiar with the business environment, the cultural environment and the legal environment, and who can run the U.S. expansion as its primary function. Given this likely preference, the franchisor’s contractual relationship with an independent operator in the U.S. is critical.

For this sort of contractual arrangement, the choice may be between a master franchise and a development agreement.

In *master franchising*, the franchisor will grant the master franchisee the right not only to establish and operate outlets owned by the master franchisee but also to sub-franchise outlets to independent sub-franchisees.³ The master franchisee will have to act as local franchisor and take on all obligations and perform all services for the sub-franchisees. The franchisor has to train the master franchisee not only in the operation of the franchise system but also in the training of sub-franchisees. As the master franchisee creates another layer in the structure, it is imperative that the training of sub-franchisees is identical to the training that the franchisor gives its local franchisees. Just a small deviation can cause vast quality differences which can be detrimental to the entire franchise system.

In *development agreements*, the area developer will be granted the right to establish and operate a number of outlets during a certain period of time. Already the fact that the area developer will not sublicense its right to others, but has to establish all outlets by itself means that an area developer is a

bigger player and usually has more financial strength. The area developer usually handles the obligations of a franchisor for the territory it has been granted. To ease the burden on the franchisor, the area developer will create the necessary network of suppliers and will maintain stock of all supplies for the territory.

If there is a choice, a development agreement is preferred over a master franchise agreement. The franchisor will get the expansion it wants but without the middle man that the master franchise structure creates.

In all licensing there is the question of how big a territory the licensor should grant the licensee. The correct answer is: You should not bite off more than you can chew. The franchisor who grants too big a territory to the master franchisee or area developer will be disappointed when the territory is not developed at the pace it expected. The master franchisee or area developer who takes on too big a territory is reckless. If the master franchisee or area developer undertakes to develop a territory that is too big and, as a result, fails to meet the development schedule, it risks losing its development rights. The way to handle the territory and the pace of development is by agreeing on a development schedule that both parties believe is feasible. In this schedule the franchisor sets its goals on how fast it wants the territory to be developed. The master franchisee or area developer will have to agree to the pace. If the development is state-by-state or area-by-area, it is easy to set goals and thresholds. If the master franchisee or area developer does not meet the goals, the exclusivity may be terminated, the territory may be decreased or the whole agreement may be terminated.

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³ In this paper, the authors have chosen to follow the master franchising nomenclature most frequently utilized by international practitioners. That is, the entity that obtains the license from the franchisor is the “master franchisee.” The master franchisee has the right to own and operate units and also the right to grant sub-franchises to third parties known as “sub-franchisees.” It should be noted that some U.S. laws refer to the master franchisee as the “sub-franchisor.”

4. If the franchisor is considering franchising “all of USA,” would it ever franchise “all of Europe,” or “all of South America” or “all of Asia” to one person? Given the size of the U.S. economy, does it make sense to think of the U.S. as a single market?

Many foreign franchisors expand to the U.S. with the naive perception that the U.S. is a single market. Too often have we seen franchisors grant a territory defined as “all of USA.” This is not the way to expand. Only a very large company will be able to handle all of the U.S. This partner probably needs to be already established in the same field or in a companion business. The risk with such a partner is that if it is so much bigger than the franchisor it may be difficult for the franchisor to negotiate a good deal for the U.S. market.

By comparing territories outside the U.S. it becomes obvious that “all of USA” is too big a territory. Nobody would grant a territory defined as “all of Europe.” The countries of Europe may, in this example be compared to the states of the U.S. Even though the states have the same currency and the same language, the laws and the culture will differ among the states.

The preferred way to expand is state-by-state or area-by-area. If the expansion is successful, the master franchisee or area developer may continue to receive more opportunities. The franchisor may grant one or more options allowing the master franchisee or area developer to expand its territory when certain levels of the development schedule are met. By starting small and allowing the master franchisee or area developer to grow bigger, the franchisor does not take risks and does not give away territories that it otherwise might have to litigate to recover.

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5. Should the franchisor adjust its franchise agreement? Why can't the franchisor use its civil law agreement as modified for the U.S.? Would it be better to start with a U.S. common law style franchise agreement?

When entering a new market there are lots of new impressions and new details for most franchisors. When negotiating and agreeing with the prospect in the new market the franchisor will want to have the comfort of its existing, standard agreement—the agreement used over the years and the agreement that has been amended after each settlement whenever a loophole was found that the franchisor was not aware of. But, is this wise? Can it be done?

This question has more than one layer and may depend on the specific agreement under consideration.

In an area development structure, the development agreement can include both the development grant and the grant to operate units with all the details concerning the operations. The development agreement can also be a two-fold system with a separate agreement for the development grant and an agreement for the operation of each unit. The latter agreement may be very much like a direct franchise agreement. In both these scenarios the franchisor will be one of the parties to the agreements and will want to have its law as the governing law. If the franchisor originates in a civil law country, it will most likely use its civil law agreement. However, there are clauses that need to be adjusted to protect the intellectual property and to enable the franchisor to seek injunctions in the U.S.

If the arrangement is based on master franchising, there are two layers of agreements: the master franchise agreement and the sub-franchise agreement. The master franchise agreement will be concluded between the franchisor and the master franchisee. Just like the development agreement, the franchisor will most likely demand that the governing law be the law of its home country, similar to most licensing agreements. If the franchisor originates in a civil law country, it will

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most likely use its civil law agreement. But, like the development agreement, it needs to be amended to enable the franchisor to protect certain rights in the U.S. The second layer of agreement – the sub-franchise agreement – will be concluded between the master franchisee and the sub-franchisees. Both these parties are established and operate in the U.S. The purpose of the agreement is tied to the U.S. In this case, it would be counterproductive to try to use the civil law agreement generally utilized by the foreign franchisor.

However, many franchisors (and their counsel) will include the original civil law agreement as a form sub-franchise agreement and require the master franchisee to modify it for the U.S. Most of us know that it is harder to modify an agreement to fit the purpose than to start from scratch. As an alternative, the franchisor can provide a checklist (based on its experience with the system outside of the U.S.) that the master franchisee will use when creating a U.S. common law style sub-franchise agreement. The master franchisee (and its counsel) must undertake to cover all rights and obligations in the checklist, and the master franchise agreement should include an indemnification clause to protect the franchisor.

6. Will the franchisor have to consider adjusting its system for the U.S. due to cultural differences or supply challenges? How will the franchisor provide sales and marketing support for the U.S. system?

Cultural differences

Just five or ten years ago, a foreign franchisor might have spent a considerable amount of time trying to determine how best to “Americanize” its concept for U.S. consumers. With the growth of the percentage

of the American marketplace now occupied by the Millennials, also known as Generation Y, those persons roughly between the ages of 17 and 35, the need to change any franchised concept to conform to what might have been considered “American” tastes and preferences has been significantly diminished. Studies show that these younger consumers are much more interested in, familiar with, and attracted to, the local feel of foreign brands. Their perspective is global and they are often called the “first truly global generation.” Many more of them have studied or travelled outside the United States than the older, more mature generations, known as the Baby Boomers and the Silent Generation, and they have global preferences.⁴ A franchise concept developed outside of the U.S. may be much more successful in the U.S. if it remains true to its origins, instead of trying to turn itself into something more “American.” The foreign franchisor also needs to consider the significance of potential American consumers who have experienced the brand abroad. The franchisor will want to minimize any changes to the concept that could endanger the loyalty of such customers when the brand arrives in the U.S.

Some successful foreign concepts also target the market of emigrants in the U.S. who are from the country where the concept was developed. In those cases, the franchisor wants to capitalize on its authenticity and heritage and successfully bring the “home country” feel of the brand to consumers in the U.S. who are already familiar with the concept.

Of course, for each particular system, relevant cultural differences should be studied and taken into account as the foreign franchisor considers entering the U.S. market. For restaurant concepts, portion sizes may need to be altered. Given the average dimensions of the American population, furniture sizes for restaurants and hotels may also need to be reviewed. Every aspect of the brand will have to be carefully considered prior to determining the exact offering for the U.S. As an example, in the hotel industry, American business travelers expect that

⁴ Christine Barton, Jeff Fromm and Chris Egan, *The Millennial Consumer* (April 2012), [http://www.brandchannel.com/images/papers/536_BCG_The_Millennial_Consumer_Apr_2012%20\(3\)_tcm80-103894.pdf](http://www.brandchannel.com/images/papers/536_BCG_The_Millennial_Consumer_Apr_2012%20(3)_tcm80-103894.pdf).

each room will have an iron and ironing board. A European hotel brand that caters to European travelers would likely not have to address a similar expectation. All such details of the concept must be carefully considered for creation of the economic model for prospective franchisees in the U.S. Additionally, Item 7 of the FTC Rule requires that the FDD disclose the estimated initial investment, including those for equipment, fixtures, other fixed assets, construction, remodeling, leasehold improvement, and decorating costs.⁵ In order to prepare an accurate and complete Item 7, every component of the concept must be considered so that the costs can be correctly reflected in the required estimates.

If the franchisor's home country and the countries where it has already expanded utilize the metric system or the Imperial system (UK), the franchisor must include in the budget for its U.S. expansion, the costs to convert all its measurements (recipes for both proprietary and non-proprietary food and beverage items) and architectural and interior designs for plans and specifications to the U.S. system of measurement.

Supply challenges

One key to a successful launch of a brand in the U.S. is the determination if products and furniture, fixtures and equipment must be imported from the home country into the U.S., with the added expense of transportation and logistics services and the payment of customs duties, if applicable, and fees, or if suppliers and manufacturers can be located in the U.S. The integrity of the brand will be at stake so the franchisor must be assured that local U.S. suppliers can meet the requirements and provide the same quality of goods and products as the brand does in its home country. If the concept includes proprietary ingredients or technology, for example, the franchisor may be hesitant to permit production of these items by any supplier other than those with which it has a long term relationship. Supply chain analysis should be undertaken very early in the investigation of whether the brand and the business model will be financially attractive for franchisees in

the U.S., particularly if any goods or inventory must be imported. If there will be a need for imported products, the franchisor will have to determine the best way of providing such distribution. It may determine to set up an entity in the U.S. that can serve as the importer of record for such products. It could consider requiring each of the franchisees to handle the importations, but if the items are critical for the success of the franchised business, such an approach may be considered unwise given timing, expertise and cost considerations.

Sales and marketing support

The franchisor must determine the amount of mandatory advertising fees the U.S. franchisees will be required to contribute so that there will be adequate funds to undertake sustained marketing efforts in the U.S. Marketing will be critical at the outset of development of franchised units in the U.S. and until there is a "critical mass" of units contributing to the advertising fund, the success of any sales and marketing campaigns will have to be driven by the franchisor and it should anticipate making loans or contributions itself into the advertising funds so that the launch of the brand in the U.S. (from a marketing perspective) is successful. The franchisor likely has sales and marketing materials it uses in its home country and it should maximize the use of the look and feel of such materials in the U.S. (with proper translations) so that the integrity of the concept and the messaging regarding those concepts remains intact. Local marketing experts who may be associated with international marketing firms that the franchisor already uses should be able to assist the franchisor in determining the appropriate style for the main marketing messages.

The franchisor will need to undertake careful research to determine if the amount of the advertising contribution required in the home country or other countries where the franchisor has units will be appropriate for the U.S. The franchisor will also have to decide if it will allow the U.S. franchisees to undertake advertising on their own, particularly when the brand is just beginning to grow in size, though given the importance to the franchisor of maintaining the integrity of the brand

⁵ 16 C.F.R. §436.5(g)(1)(i)(D).

and the messaging regarding the brand, this possibility is not one that we see utilized with assured success. Whatever the franchisor does determine as to the advertising fees and the utilization of those fees must be described in Items 6 and 11 of the FDD.⁶ Item 11 requires a significant amount of information be disclosed about the advertising program of the franchised system: the media the franchisor may use, a description of the media as local, regional or national, the source of the advertising, where the money will be spent, when the franchisor will allow franchisees to use their own materials, substantial details regarding any advertising council of franchisees, any advertising cooperative, and any advertising fund.

7. Will the franchisor have to adjust its franchise business model due to different laws?

Whether the franchisor will have to adjust its business model is going to depend on many factors, but most particularly on how the franchisor has set up its model in its home country and its details, the level of any applicable disclosure requirements with which it is already complying, and the development of franchisor liability concerns in its home country.

Many experts consider that the U. S. has one of the most detailed franchise sales disclosure requirements in the world. While the FTC Rule requires many disclosures, what follows are a couple of examples that could have bearing on whether the franchisor will need to adjust its business model. Item 8 of the FDD⁷ must include information about any payments designated suppliers may make to the franchisor from franchisee purchases. If the arrangement with suppliers in the home country includes rebates or other payment benefits for the franchisor related to such purchases and there is no obligation to disclose them, the franchisor may have simply included such payments in its income. The Item 8 disclosure does not, of course, dictate what the franchisor must do with rebates, but the transparency required regarding the payments and

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the practice of U.S. franchisors in similar businesses may lead the franchisor to allocate all or a portion of such monies to programs or initiatives, such as advertising, that will benefit the franchisees.

Another requirement of the FTC Rule is that Item 11 of the FDD⁸ includes significant information about any advertising fund and a description of how the funds were used in the prior year as well as a breakdown by percentages spent on various uses. If the franchisor is not required by its home country laws to disclose how the contributions from franchisees for advertising funds are spent, it could have a practice of handling such monies in a way that would not be customary for U.S. franchisors. It could, for example, pay a significant amount of the contributions to its affiliates for certain advertising services that may not be provided at competitive prices. Perhaps, it does not spend the monies each year or commingles them with some of its own funds. Again, Item 11 does not dictate what the franchisor must do with the advertising funds, but the level of disclosure could cause the franchisor to reconsider some of its practices.

⁶ 16 C.F.R. §436.5(f)(1), 16 C.F.R. §436.5(k)(4).

⁷ 16 C.F.R. §436.5(h)(8).

⁸ 16 C.F.R. §436.5(k)(D)(v)(G).

In order to make certain that all franchisees represent the franchised system and use its trademarks in compliance with the standards, franchisors around the world create programs and tools and means of assuring this compliance. The challenge for foreign franchisors coming to the U.S. from home countries that have not yet developed theories for holding the franchisor liable for claims arising in connection with the franchisees' operation of the franchised business will be how to evaluate the franchisor's control of such operation in order to determine how the business model may need to be revised to better insulate the franchisor from such liability in the U.S. Over the last fifty years of franchising in the U.S., there have been many claims asserting that the franchisor should be held responsible for the actions of the franchisee since the control of the franchisor over the day to day operations of the franchisee created a principal-agent relationship. If there is a determination of such a relationship, the franchisor can be held liable by a third party for the tortious acts of the franchisee even though the franchisor was not at fault. Some of the cases have been based on the doctrine of "apparent agency." In order to negate the appearance of such a relationship, many U.S. franchisors insist that all franchisees post specific notices in the outlet indicating that it is independently owned and operated. Claims of franchisor direct liability as well as vicarious liability are generally decided based on the applicable state law that has developed from prior cases as well as a complete review of all relevant facts. While a detailed explanation of these legal theories is beyond the scope of this paper, an overview and an introduction to some of these cases, including those relating to employment matters as well as accessibility requirements can be found in the chapter entitled "Franchise System Operational Issues" in The Franchise Law Compliance Manual.⁹

⁹ Brian Cole, Andra Terrell, John Richardson, and Sandra Wall, *Franchise System Operational Issues*, THE FRANCHISE LAW COMPLIANCE MANUAL (J. Brimer ed., ABA Forum on Franchising, 2d ed, 2011) (2000).

8. How will the franchisor handle inspections or perform quality control?

If the franchisor has determined to create a subsidiary in the U.S. to provide support for the franchise system, it may determine to hire its own local employees who can undertake inspections of the franchised businesses. Of course, these employees will have to be trained in the culture of the franchisor and likely will have to spend a significant amount of time in the franchisor's home country to learn about the system and the operation of the units in order to be prepared to conduct inspections of the U.S. units. Alternatively, the franchisor may have created an in-house team who inspect the foreign units, both in the home country as well as in other locations where the franchisor has expanded prior to its entry into the U.S. Any such non-U.S. citizens who come to the U.S. for such inspection work will have to obtain a non-immigrant visa, a process that can be very simple or complicated and time-consuming, depending on the citizenship of such person. Inspections can also be handled by independent third parties who have been provided with the criteria for such review. Mystery shoppers are another tool that some franchisors utilize. Customer satisfaction surveys may also serve as a tool for quality control. All of these methods may be combined, but as the franchisor considers its entry into the U.S. it will be imperative to establish a budget for these activities and determine whether the funding will be provided through charges to the franchisees or not. Inspections and the quality

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assurance program must be thorough, transparent, and non-discriminatory so that failures of quality can be addressed and, if not properly addressed, serve as the basis for the legitimate termination of the franchise agreement. The program can also serve to diminish the likely success of any liability claims against the franchisor for negligence in carrying out its obligations to assure that the franchised units are operated in compliance with the system standards.

The franchisor should plan on utilizing the fundamentals of the program it has developed for the brand in the home country so as to minimize costs and to establish consistency in the brand across all the countries where it has franchised units.

9. How will the franchisor provide training for its U.S. system? Are there ways to minimize personnel and translation costs?

The foreign franchisor should begin with its existing written training programs and materials. If these materials do not already exist in English, in all but a few unique circumstances, they will have to be translated and the costs for such translations can be significant. And if they have been previously translated, but into an English version other than “American English,” they will likely need to be reviewed and revised in order for Americans to be able to utilize them successfully. Some foreign franchisors entering the U.S. have chosen to do so through their home country nationals who have emigrated to the U.S. and who are fluent in the home country language. In that case, written training materials may not have to be translated immediately. Additionally, if the franchisor expects that the franchised businesses will be operated by a diverse

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workforce, it will need to contemplate the possibility that certain training materials will not only have to be translated into English, but also into Spanish or another foreign language, depending on the ethnicity of the workforce. These additional translation costs can be significant.

Another important factor in determining the financial viability of the concept in the United States is consideration of the cost to franchisees if in-person training is going to be provided. Whether the training occurs in the home country of the franchisor or in certain locations in the U.S., the additional cost of lodging and transportation has to be considered. At the outset, the franchisor must decide how it will handle training of its franchisees in the U.S and all training programs and the timing for such programs and the costs of such programs have to be described in detail in Item 11 of the FDD.¹⁰

The franchisor may be able to minimize costs by having a substantial amount of its training program provided through on-line tools, including self-paced programs or webinars or on-the-job training programs. It may be also possible to consider developing successful franchisees into local trainers, but this possibility will not exist at the outset as the franchisor prepares for the launch of the brand in the U.S.

10. What kinds of laws will apply to the U.S. operation of a foreign brand?

The foreign brand will be subject to a host of federal, state and local laws and regulations depending on the franchise business model. On the federal level, the foreign franchisor will need to make certain that the brand in the U.S. is designed and can operate in compliance with the Americans with Disabilities Act of 1990 (the “ADA”)¹¹ which provides that all facilities made available to the public or places of public accommodation are accessible to persons with disabilities, including restaurants, hotels, stores, etc. As the franchisor develops its design standards and operating standards for its U.S. franchisees, review for

¹⁰ 16 C.F.R. §436.5(f)(1), 16 C.F.R. §436.5(k)(7).

¹¹ 42 U.S.C. §§12101-12213 (1997).

compliance with the ADA is critical. If the franchise involves swimming pools or whirlpools, the federal Virginia Graeme Baker Pool and Spa Safety Act¹² will apply to them.

Obviously, there are state and local ordinances and regulations regarding building requirements for all franchises operated out of a particular location and health and life safety regulations that are of particular importance to any food or beverage franchise or those that involve dangerous chemicals, such as dry cleaning or laundry services. State and local health statutes, regulations and federal Occupational Safety and Health Administration (OSHA) laws cover workplace safety and cleanliness. Local laws address sanitation, food storage, cleaning, water supply, sewage, toxic materials, personnel and equipment. Some states have adopted truth-in-menu statutes or regulations that require descriptions of ingredients as well as calorie counts in servings. Sales of alcoholic beverages are controlled by state, county or local liquor authorities. There are also federal labeling requirements for many products.

Some other laws that the franchisor needs to consider are those that relate to U.S. anti-terrorism efforts and the prohibitions on U.S. companies from doing business with countries and their nationals subject to U.S.-imposed economic sanctions as well as those persons included on the lists maintained by the U.S. Treasury Department's Office of Foreign Assets Control (OFAC) and the Department of Commerce, generally referred to as SDNs (Specially Designated Nationals), Blocked Persons, Denied Persons or the Entity List.¹³ These are federal laws that apply to all companies in the U.S. as well as all U.S. citizens and all permanent resident aliens, located both inside and outside the United States. Once the foreign franchisor establishes a branch or subsidiary in the United States, it must assure that its potential suppliers, franchisees and any other

persons with whom it will establish a business relationship are not on the lists of prohibited parties which are constantly updated by OFAC and the other government agencies.

The foreign franchisor's branch or subsidiary in the U.S. will also be subject to the U.S. anti-boycott laws which prohibit U.S. companies from participating in foreign boycotts that are not supported by the U.S., the primary example of which has been the Arab League boycott of Israel. Any support of a non-sanctioned boycott, such as an agreement not to business with Israel is prohibited and certain requests for information cannot be answered and must be reported in a timely fashion to the Department of Commerce and the Internal Revenue Service of the Department of the Treasury.¹⁴

“Once the foreign franchisor establishes a branch or subsidiary in the United States, it must assure that its potential suppliers, franchisees and any other persons with whom it will establish a business relationship are not on the lists of prohibited parties”

¹² 15 U.S.C. §§8001-8008 (2008).

¹³ See the OFAC website for information on the various U.S. sanctions programs: <http://www.treas.gov/offices/enforcement/ofac/programs>. See also the Bureau of Industry and Security website: <http://www.bis.doc.gov>.

¹⁴ 15 C.F.R. Part 760.

11. Does the franchisor need a U.S. federally registered trademark?

Neither the FTC Franchise Rule nor any of the state franchise sales law requires that the franchisor have a U.S. federally registered trademark to use with its U.S. franchise program. Nevertheless, there are practical and legal reasons why a federally registered trademark would be desirable.

Item 13 of the FTC Franchise Rule requires that the FDD disclose each principal trademark to be licensed to the franchisee.¹⁵ “Principal trademark” means the primary trademarks, service marks, names, logos and commercial symbols used to identify the franchised business. The franchisor has to disclose whether the principal marks are registered with the U.S. Patent and Trademark Officer (“USPTO”). If not registered with the USPTO, the franchisor has to disclose whether it has filed a trademark application, including any “intent to use” application or application based on actual use. If the mark is not registered, the FTC Rule requires the following statement in the FDD:

We do not have a federal registration for our principal trademark. Therefore, our trademark does not have many legal benefits and rights as a federally registered trademark. If our right to use the trademark is challenged, you may have to change to an alternative trademark, which may increase your expenses.¹⁶

If a mark is not registered, there is a risk that another party could use a similar or identical mark and obtain a common law right in the mark in a specified area of prior use. That would mean that the franchisor would not be able to grant a franchise

“... there are practical and legal reasons why a federally registered trademark would be desirable.”

¹⁵ 16 C.F.R. §436.5(m)(1)

¹⁶ 16 C.F.R. §436.5(m)(4).

using the mark in that area of prior use. In addition, the franchisor would have to disclose in its FDD if it knows of either superior prior rights or infringing uses that could materially affect the franchisee’s use of the principal marks in the state where the franchise will be located.¹⁷ Even worse, the infringing party may seek to register its own mark. The risk to the franchisor if it uses an unregistered mark is that the franchisor may have to modify its trademarks or discontinue using a trademark, which then raises the practical issue of which party would bear the cost of modifying the marks used by the franchisees. Brand identity is critical to a successful franchise program, and having to change or modify a mark could have a negative impact on the franchise system.

There is another reason to obtain federally registered trademark. Franchisors with registered trademarks that provide sales or marketing plans can be exempt from the business opportunity laws in many states. (See Question 16)

For the reasons discussed above, the franchisor should have a U.S. federally registered trademark for its U.S. franchise program.

12. Should a U.S. subsidiary be formed to license and operate the franchise program? If so, how does the franchisor determine in which state to organize it?

Usually the franchisor would consider forming a U.S. subsidiary to license and operate the franchisor under one or more of three circumstances:

1. if it wants to have a presence in the country to support the U.S. franchise operations or conduct company-owned operations,
2. to comply with the FTC Franchise Rule’s financial statement requirements for the FDD disclosure, and/or
3. to minimize its liability risk exposure.

¹⁷ 16 C.F.R. §436.5(m)(9).

“For tax reasons, and perhaps liability reasons, the franchisor may want to avoid having a branch office in the U.S.”

If the franchisor plans to have its personnel stationed in the U.S. to support its U.S. franchise operations or conduct its own operations, it would be prudent to set up a U.S. subsidiary to conduct those operations. For tax reasons, and perhaps liability reasons, the franchisor may want to avoid having a branch office in the U.S. The personnel stationed here would have to obtain the appropriate business visa to allow them to work in the U.S., which may be easier to obtain if there is a local subsidiary. We have found that such personnel not infrequently eventually obtain a U.S. “green card” allowing them to live and work in the U.S. as a resident alien.

Perhaps the most onerous part of preparing the FDD required by the FTC is the need to have audited financials prepared in accordance with U.S. GAAP. (See Question 15) Most foreign franchisors establish a U.S. subsidiary to license and operate the program, adequately capitalize it, and then obtain an audited opening balance sheet prepared in accordance with U.S. GAAP.

There is no magic to selecting a state in which to organize a subsidiary. Most likely a corporate subsidiary would be established rather than a limited liability company. The state of organization can be the state in which the principal place of business will be located or a state with flexible corporate laws, such as Delaware. To some extent, the state of organization may depend on how extensive the franchisor thinks the U.S. operations will be. The franchisor should make sure, however, that the state of organization does not have restrictions on whether a non-resident may be a director or officer of the new entity or other restrictions on foreign ownership of the local corporation or real estate.

If the entity is organized in a state with a flexible corporate law but operations are based in another state, the new entity will have to qualify to do

business in the other state. This is not a difficult task. It simply requires filing an application to do business in the other state and paying the requisite filing fees and applicable taxes.

Many foreign companies are attracted by the lure of New York City. We recommend against placing the franchisor’s base of operations in New York because New York is the only state that claims that its Franchises Law has extraterritorial application.¹⁸ While the New York Department of Law may have no objection to a franchisor following the FTC Franchise Rule’s 14 calendar-day disclosure timing requirement, a disgruntled franchisee from another state may claim that failure to disclose with the New York FDD violates the law and give them a private remedy.¹⁹ This can prove to be a serious nuisance if the franchisor plans to sell franchises in states other than New York because its New York registered FDD would have to be provided to prospective franchisees arguably at the earlier of the first personal meeting to discuss the offer or sale of a franchise, or 10 business days before signing any agreements or payment of any consideration.²⁰

“We recommend against placing the franchisor’s base of operations in New York because New York is the only state that claims that its Franchises Law has extraterritorial application.”

¹⁸ See *Monshore Management, Inc. v. Family Medico, Inc.*, 584 F. Supp. 186, CCH Business Franchise Guide ¶8150 (S.D.N.Y. 1984); *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*, 795 F. Supp. 2d 365, CCH Business Franchise Guide ¶14,633 (D. Md. 2011); but see *JM Vidal, Inc. v. Texdis USA, Inc.*, 764 F. Supp. 2d 599, CCH Business Franchise Guide ¶14,560 (S.D.N.Y. 2011).

¹⁹ See David Kaufmann, *New York Franchise Act Commentary*, in McKinney’s Gen. Bus. Law Ch. 20, Art. 3, Refs & Annos, at 24 (2012)

²⁰ NY Gen. Bus. Law §683.8.

13. What are the tax implications for the franchisor that are different from its prior experience of franchising in a neighboring country?²¹

The U.S. tax implications of a foreign franchisor entering into the U.S. market depend upon the ownership structure of the franchise. Foreign franchisors may enter the U.S. market by either (i) entering into a franchise agreement, development agreement or master franchise agreement directly with an unrelated party; or (ii) forming a U.S. subsidiary to serve as a base of operations in the U.S. or as a joint venture partner.

Franchise or other agreement

If a foreign franchisor decides to enter into a franchise or other agreement directly with an unrelated party, which apparently may not be done very often, the tax treatment of the foreign franchisor depends on whether or not the franchisor is deemed to be engaged in a U.S. trade or business. While there is no comprehensive definition of a U.S. trade or business, activity in pursuit of profit that is considerable, continuous and regular is necessary to establish a trade or business.²² Isolated or occasional activities and passive investments are usually insufficient to create a U.S. trade or business. Case law and Revenue Rulings issued by the Internal Revenue Service generally provide clarification based upon the franchisor's level of activity.

“If the foreign franchisor is a resident in a country that has an income tax treaty with the U.S., income is taxable by the U.S. only to the extent that the income is attributable to a U.S. permanent establishment...”

²¹ Cassie L Barr of the St. Louis office of Greensfelder, Hemker & Gale, P.C. (“Greensfelder”) assisted in the preparation of the response to Question 13.

²² *Pinchot v. Commissioner*, 113 F.2d 718, 719 (2d Cir. 1940).

If a foreign franchisor is deemed to be engaged in U.S. trade or business, the franchisor will be taxed according to the following rules.

- First, the franchisor will be taxed on all of its income effectively connected with the U.S. trade or business in the same manner as if it were a U.S. corporation.²³ Effectively connected income (“ECI”) generally includes all U.S. source income of the foreign franchisor, as determined under Internal Revenue Code Section 861.²⁴
- Next, some of the franchisor's foreign source income, as described in Code Section 864(c)(4)(B), may also be considered ECI and subject to U.S. tax if there is an office or other fixed place of business within the U.S. Such foreign source income includes income from intangible property, income from a banking or securities business and income from sales of inventory property.²⁵
- In addition to ECI, a foreign franchisor that opens a branch office in the U.S. will be subject to a second level of tax at a rate of 30% when income is repatriated from the U.S. to its foreign home office.²⁶

A tax treaty between the U.S. and the foreign franchisor's home country may protect the franchisor from taxes arising from ECI or reduce their impact. If the foreign franchisor is a resident in a country that has an income tax treaty with the U.S., income is taxable by the U.S. only to the extent that the income is attributable to a U.S. permanent establishment (“PE”).²⁷ The definition of what constitutes a PE is dependent upon the treaty. Some countries, like the United Kingdom, define a PE as a fixed place of business through which the business of an enterprise is wholly or partly carried

²³ I.R.C. §882.

²⁴ I.R.C. §882(b)(1).

²⁵ I.R.C. §864(c)(4)(B).

²⁶ I.R.C. §884(a).

²⁷ See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains, U.S.-U.K., art. 5, July 24, 2001, T.I.A.S. 13161. (“U.S. – U.K. Tax Treaty”).

on.²⁸ While the definition of ECI and PE may be similar, generally a more stable presence is required to constitute a PE.

Another primary consideration for foreign franchisors is that U.S. sourced fixed or determinable annual or periodic (“FDAP”) income that is not ECI, and therefore not subject to the direct tax discussed above, will still be subject to a U.S. withholding tax of 30%.²⁹ Because the definition of FDAP income includes royalty payments, a U.S. franchisee must ordinarily withhold 30% of its royalty payments to the foreign franchisor.³⁰ Some franchisors try to address this problem by having its franchisees “gross up” their royalty payments to cover the withheld amounts. The U.S. has tax treaties reducing the withholding tax rate to 10% or lower for many, but not all, countries. Tax treaties in some countries, like the United Kingdom, provide for a U.S. exemption on such withholding.³¹

U.S. subsidiary

Alternatively, if a foreign franchisor forms a U.S. subsidiary to serve as a base of operations in the U.S. or to serve as a joint venture partner, which is the more common approach, the profits earned by the U.S. subsidiary would be taxed up to 35%.³² In addition, the repatriation of profits (i.e., dividend distribution) by the U.S. subsidiary to the foreign franchisor is subject to a withholding tax of 30%.³³ Tax treaties between the U.S. and foreign countries typically reduce the dividend withholding tax.

“... a U.S. franchisee must ordinarily withhold 30% of its royalty payments to the foreign franchisor.”

Other tax issues

A number of the states have been very aggressive in recent years in trying to tax the activities of the franchised businesses in their jurisdictions, among them California and South Dakota. Some states impose a tax on the franchisee who must withhold taxes and pay them to the state, and other states impose the tax directly on the franchisor on the theory that the franchisor is, in effect, doing business in the state.

One of the major issues in franchising today is whether the franchisee is truly an independent contractor or an employee of the franchisor. So far these challenges have come from several states which are seeking to collect unemployment compensation or worker’s compensation premiums for the state,³⁴ or from franchisees who say they were misclassified as independent contractors.³⁵ Because this is becoming an increasing problem, Delaware recently amended its Delaware Franchise Security Law to state that franchisees are not to be deemed employees under the state’s Wage Payment and Collection Act.³⁶

²⁸ *Id.*

²⁹ I.R.C. §1442(a).

³⁰ I.R.C. §§1441(b) and 1442(a).

³¹ U.S. – U.K. Tax Treaty.

³² I.R.C. §11.

³³ I.R.C. §1442(a).

³⁴ See, e.g., *Coverall North America, Inc. v. Commissioner of The Division of Unemployment Assistance*, CCH Business Franchise Guide ¶13,491 (Sup. J. Ct. Mass. 2006).

³⁵ See, e.g., *Awuah v. Coverall North America, Inc.*, CCH Business Franchise Guide ¶14,671 (Sup. J. Ct. Mass. 2011); *Awuah v. Coverall North America, Inc.*, CCH Business Franchise Guide ¶14,349 (D. Mass. 2010).

³⁶ Delaware Code, tit. 6, ch. 25, §2554.

14. How does the franchisor go about preparing a franchise disclosure document and registering it?

The franchisor will need local counsel in the U.S. to help it prepare and register an FDD. The first step is to understand the controlling regulations and laws. The content of the FDD is mandated by the FTC Franchise Rule. The FTC has issued Amended Franchise Rule FAQ's³⁷ to provide guidance to franchisors. The North America Securities Administrators Association ("NASAA") issued the 2008 Franchise and Registration Disclosure Guidelines³⁸ and a Commentary on the 2008 Franchise Registration and Disclosure Guidelines³⁹ to provide further guidance on the disclosure and state registration process. A number of the franchise registration states require that certain additional state specific disclosures be included in the FDD, usually in an addendum.

U.S. local counsel will generally provide the franchisor with a detailed questionnaire that can be used to gather the information that will be needed to prepare the first draft of the FDD. There is no substitute, however, for a direct telephonic or face to face meeting with the preparer to gather the information needed to prepare the FDD. Many disclosures in the FDD need to reflect certain provisions in the Franchise Agreement and other documents used in the franchise sales process. A practical issue is – what should be prepared first: the Franchise Agreement or the FDD? Some lawyers prefer to prepare the Franchise Agreement first, while franchise consultants often prefer to draft an FDD first.

Two of the more critical disclosures are the audited financials to be attached to the FDD (See Question 15) and the attachment to the FDD of a copy of each agreement to be signed by the franchisee.

The preparation of the initial FDD can take several weeks or months because it is a detailed disclosure in 23 items. It is difficult to rush the process of preparation. Once the FDD is ready, it needs to be registered in 13 states before a sale or offer of a sale of a franchise can be made that is subject to the laws of those states.⁴⁰ Nine of those states may review and comment on the disclosures in the FDD⁴¹ and require revisions. In the other four states, the registration is effective upon filing or shortly thereafter.⁴² A challenge for the franchisor is determining in which states to file a registration application. While it is tempting to file in all registration states at the same time, that may not be necessary or prudent. To the extent possible, most franchisors try to use one multistate FDD for sales in all states, but sometimes that is not possible.

“Once the FDD is ready, it needs to be registered in 13 states before a sale or offer of a sale of a franchise can be made that is subject to the laws of those states.”

³⁷ <http://www.ftc.gov/bcp/franchise/amended-sales/faqs.shtml>.

³⁸ http://www.nasaa.org/industry_regulatory_resources/uniform_forms/3697.cfm.

³⁹ http://www.nasaa.org/Industry_Regulatory_Resources/Franchisee/.

⁴⁰ Registration is required in all of the 15 disclosure states except Oregon (Oregon only requires compliance with the FTC Franchise Rule) and Michigan (only a simple notice filing is needed).

⁴¹ California, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, Virginia and Washington.

⁴² Hawaii (7 days after filing), Indiana, South Dakota and Wisconsin.

15. What financial statements should the franchisor use for the FDD? If the franchisor sets up a subsidiary to handle the U.S. operations, when would the parent's financials have to be included in the FDD?⁴³

Item 21 of the FTC Franchise Rule requires the franchisor to attach to the FDD financial statements prepared “according to United States generally accepted accounting principles (“U.S. GAAP”), as revised by any future United States government mandated accounting principles, or as permitted by the Securities and Exchange Commission (the “SEC”).”⁴⁴ The financial statements must be audited by an independent certified public accountant using generally accepted U.S. auditing standards. The financials need to include two years of balance sheets and three years of statements of operations, stockholders equity and cash flows.⁴⁵

Instead of the franchisor's own financials, the franchisor can include the financial statements of any of its affiliates if the affiliate's financial statements are prepared as discussed above and the affiliate absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor under the franchise agreement. The guarantee has to be attached to the FDD.⁴⁶

If the franchisor uses its own financials in the FDD and it owns a controlling financial interest in a subsidiary, its financial statements should reflect the condition of the franchisor and its subsidiary.⁴⁷ These are called “consolidated financials.”

The FTC Franchise Rule allows a start-up franchise system that does not yet have financial statements to phase in audited financials over three years.⁴⁸

⁴³ Beata Krakus of the Chicago office of Greensfelder assisted in the preparation of the response to Question 15.

⁴⁴ 16 C.F.R. §436.5(u)(1).

⁴⁵ 16 C.F.R. §436.5(u)(1)(i) and (ii).

⁴⁶ 16 C.F.R. §436.5(u)(1)(iii). The NASAA 2008 Franchise and Registration Guidelines include a Guarantee of Performance (Form E).

⁴⁷ 16 C.F.R. §436.5(u)(1)(iv).

⁴⁸ 16 C.F.R. §436.6(u)(2).

However, because some registration states will not allow the use of unaudited financials, many lawyers recommend that the franchisor use an audited opening balance sheet for a newly formed subsidiary that will engage in franchise activities or act as the guarantor.

Impact on foreign franchisors

The financial statement requirement in the FTC Franchise Rule directly impacts foreign franchisors whose financial statements may be prepared in accordance with accounting standards other than U.S. GAAP, such as those prepared under the International Financial Reporting Standards (“IFRS”). It is not clear what “permitted by” the SEC means. Although the U.S. has been considering the adoption of IFRS, that is not likely to happen for some time. However, the SEC now permits IFRS use in some situations.

“The financial statement requirement in the FTC Franchise Rule directly impacts foreign franchisors whose financial statements may be prepared in accordance with accounting standards other than U.S. GAAP”

To assist foreign franchisors in complying with audited financial statements requirement, the FTC stated in the FTC Compliance Guide:

The amended Rule permits foreign franchisors to use United States GAAP or to reconcile their financial statements to United States GAAP, consistent with SEC law.⁴⁹

The FTC also issued FAQ No. 17 on how financial statements can be audited by a Canadian chartered accountant or other foreign accountant. A copy of the FAQ is attached. Without going into great detail, the FTC said:

Under SEC rules, financial statements must be prepared using GAAP (or in accordance with another comprehensive basis of accounting standards, with an audited reconciliation to U.S. GAAP). In addition, foreign auditors, like their American counterparts, must satisfy independence requirements.⁵⁰

It then concluded:

Applying these principles, Commission staff believes that foreign accountants or accounting firms may audit financial statements for Franchise Rule purposes consistent with PCAOB [Public Company Accounting Oversight Board] and SEC policies. That means that all foreign accounting firms wishing to prepare audited financials under the Franchise Rule must: (1) be registered with PCAOB; and (2) recently audited one or more financial statements that have been filed and accepted by the SEC.⁵¹

As a practical matter, most foreign franchisors decide to set up a U.S. subsidiary to conduct their U.S. franchise program. That allows them to use the financials of the U.S. subsidiary for the FDD because they will be prepared in accordance with U.S. GAAP. But what if the foreign franchisor does not want to set up a U.S. subsidiary? The foreign franchisor can prepare its financial statements in accordance with U.S. GAAP, but this may be inconvenient and costly, especially if the financials have already been prepared and audited in accordance with IFRS. But can it use its IFRS

financials in the FDD? While FAQ No. 17 arguably allows the use of financial statements prepared in accordance with IFRS if those statements are reconciled in accordance with U.S. GAAP and the accountant's independence is established, a recent survey of the FTC and several state examiners revealed no memory of the use of such reconciled statements and a reluctance by several state examiners to allow their use. Some state examiners apparently believe their state's franchise sales law requires the use of financials prepared only in accordance with U.S. GAAP.

None of the federal or state franchise authorities we talked with seem to know what it means to use financial statements "permitted" by the SEC. Let us offer a plausible explanation. Notice that the FTC Franchise Rule says "permitted," not "filed". The SEC is now under certain circumstances accepting audited financials prepared in accordance with IFRS without any U.S. GAAP reconciliation for the IFRS financial statements of foreign private issuers that file an SEC Form 20-F. A foreign private issuer is defined in SEC Rule 405 as:

- (1) The term foreign private issuer means any foreign issuer other than a foreign government except for an issuer meeting the following conditions as of the last business day of its most recently completed second fiscal quarter:
 - (i) More than 50 percent of the outstanding voting securities of such issuer are directly or indirectly held of record by residents of the United States; and
 - (ii) Any of the following:
 - (A) The majority of the executive officers or directors are United States citizens or residents;
 - (B) More than 50 percent of the assets of the issuer are located in the United States; or
 - (C) The business of the issuer is administered principally in the United States.⁵²

⁴⁹ FTC Franchise Rule Compliance Guide p. 113 (May 2008).

⁵⁰ Amended Franchise Rule FAQs, number 17, at <http://www.ftc.gov/bbcp/franchise/amended-rule-faqs.html>. ("FAQ")

⁵¹ *Id.*

⁵² 17 C.F.R. §230.405.

The ability to use U.S. GAAP, IFRS or local GAAP was described in a publication by Latham & Watkins and KPMG as follows:

US domestic companies must file financial statements with the SEC in accordance with US Generally Accepted Accounting Principles (US GAAP). The financial statements of foreign private issuers however, may be prepared using US GAAP, International Financial Reporting Standards (IFRS), or local home-country generally accepted accounting principles (local GAAP). In the case of foreign private issuers that use the English-language version of IFRS as issued by the International Accounting Standards Board (IASB IFRS), no reconciliation to US GAAP is needed. By contract, if local GAAP or non-IASB IFRS is issued, the consolidated financial statements (both annual and interim) must include a note reconciliation to US GAAP.⁵³

The eligibility requirements to omit GAAP reconciliation were described in a Simpson Thacher publication as follows:

To be entitled to omit the U.S. GAAP reconciliation under the new rules, a foreign private issuer must satisfy the following conditions:

- the financial statements must be prepared in accordance with the English language version of IFRS as published by the International Accounting Standards Board (the “IASB”);
- the foreign private issuer must state in the notes to the financial statements that those financial statements are in compliance with the IFRS as issued by the IASB; and
- the foreign private issuer must provide an unqualified auditor’s report stating that the financial statements are in compliance with IFRS as issued by the IASB.⁵⁴

When the SEC modified its Rules in 2008, it said:

The Commission has long viewed reducing the disparity between the accounting and disclosure

⁵³ Latham & Watkins and KPMG, *Financial Statement Requirements in US Securities Offerings: What Non-US Issuers Need to Know*, at 1 (2011 Edition), found at: http://www.lw.com/upload/pubContent/pdf/pub4371_1.pdf

⁵⁴ Simpson Thacher, *SEC Eliminates U.S. GAAP Reconciliation for IFRS Financial Statements of Foreign Private Issuers*, at 1 and 2 (February 20, 2008), found at http://www.stblaw.com/google_file.cfm?TrackedFile=4B46116100D8F48682B3&TrackedFolder=585C1D235281AED996A07D5F9F9478AB5A90188899.)

practices of the United States and other countries as an important objective both for the protection of investors and the efficiency of capital markets.⁵⁵

It then explained:

Towards this end, the Commission has undertaken several measures to foster the use of International Financial Reporting Standards (“IFRS”), as issued by the International Accounting Standards Board (“IASB”) and fully supports the efforts of the IASB and the Financial Accounting Standards Board (“FASB”) to converge their accounting standards.⁵⁶

And in its Summary of its amendments, the SEC said:

In summary, the Commission is adopting amendments that:

- Permit foreign private issuers to file financial statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP; . . . (Emphasis Supplied)⁵⁷

Because the SEC is permitting the use of IFRS financials, it seems that FTC FAQ 17 may be out of date with respect to the reference to other accounting standards having to be reconciled with U.S. GAAP, at least insofar as foreign private issuers filing Form 20-F are concerned. Query, are there any such foreign private issuer franchisors? The FTC Franchise Rule explicitly states that it will follow the SEC’s lead with respect to the accounting standards that will be accepted. In other words, if it is good enough for the SEC, it should be good enough for the FTC Franchise Rule. Thus, if a franchisor satisfies the SEC requirements for using the English language version of IFRS audited financials,⁵⁸ it is arguable (but by no means a

⁵⁵ SEC Release No. 33-8879, 34-57026; International Series Release No. 1306; File No. 57-13-07; 73 Fed. Reg. 986 (Jan. 4, 2008).

⁵⁶ *Id.* at 987.

⁵⁷ *Id.* at 988.

⁵⁸ The SEC’s proposed rule revision referred to “the approved English language version of IFRS as published by the IASB”, but the final Rule referred to it as the “IFRS as issued by the IASB” because the authoritative text of the IFRS is that published by the IASB in the English language. *Id.* at 993.

“... a foreign franchisor that sets up a U.S. subsidiary to conduct its U.S. franchise operations has to take care not to have its parent involved in a formal arrangement to provide post-sale services to or for the benefit of franchisees.”

guarantee) that a foreign franchisor should be able to do so in an FDD even without reconciling the statements with U.S. GAAP.

What, if anything, can be done about the franchise examiners knowledge or experience with foreign franchisor financials? First, a conservative approach would be first to clear the use of the IFRS audited financials with the FTC, but the FTC may not be willing to opine on their use. The franchisor would then use them at its own risk. Second, the state examiners would have to be asked if they would allow the use of IFRS financials in a registered FDD without reconciliation or with reconciliation to U.S. GAAP. Whether a franchisor could use IFRS statements in an FDD with or without reconciliation apparently would be a matter of first impression for both the FTC and the state franchise examiners, notwithstanding FAQ No. 17. If a negative response is received, such as because the use of IFRS financials only applies to franchisors that file Form 20-F, the alternative for the foreign franchisor would be either (1) to use a U.S. organized company (or perhaps a U.S. guarantor entity) that has its own financials prepared in accordance with U.S. GAAP, or (2) to have its own financials prepared using U.S. GAAP.

Use of the parent’s financials

The FTC Franchise Rule also requires that the FDD contain the separate financial statements for the franchisor and any master franchisee, as well as for any parent that commits to perform post-sale obligations for the franchisor or guarantees the

franchisor’s obligations.⁵⁹ The requirement that a franchisor’s parent’s financials be attached raised a concern about the scope of this requirement. Moreover, the parent’s financial statements are subject to the same audit standards as those of the franchisor. In FAQ No. 16.D, the FTC clarified that the disclosure of parent financial information is required only when the parent commits to perform post-sale obligations for

the direct benefit of franchisees. Agreements between a franchisor and its parent for administrative and other services for the franchisor’s internal purposes do not trigger the parent financial disclosure requirements.⁶⁰

Disclosure is required where the parent commits or guarantees to perform more than an isolated obligation to franchisees on behalf of a franchisor. A footnote clarifies that the requirement “is intended to cover formal arrangements between the parent and franchisor for the benefit of franchisees or formal arrangements directly between the parent and franchisees.”⁶¹ Another footnote clarifies that this requirement does not apply to an affiliate unless it qualifies as a “parent” and commits to perform or guarantees the franchisor’s post-sale obligations.⁶²

Thus, a foreign franchisor that sets up a U.S. subsidiary to conduct its U.S. franchise operations has to take care not to have its parent involved in a formal arrangement to provide post-sale services to or for the benefit of franchisees. Because the requirement that the parent’s financials be attached to the FDD does not apply to affiliates that provide such post-sale services, careful structuring can eliminate the parent financials as an issue.

⁵⁹ 16 C.F.R. §436.5(u)(1)(v).

⁶⁰ FAQ 16.D.

⁶¹ FAQ 16.D, n. 6.

⁶² FAQ 16.D, n.5.

16. What are the costs and the process for making state franchise registration and business opportunity law filings? When does the franchisor have to worry about business opportunity laws?

The states that require registration of franchise offerings are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

As a starting point, a franchisor generally begins by preparing an FDD in compliance with the requirements of the FTC Rule. NASAA's 2008 Franchise Registration and Disclosure Guidelines⁶³ mandate the use of a state cover page immediately following the cover page required by the FTC Rule. In addition these Guidelines require the disclosure in the Receipt pages of delivery requirements in some states (Michigan, New York and Rhode Island) that differ from those required by the FTC Rule.

The FTC Rule provides that states may impose additional disclosure requirements.⁶⁴ As a result, a franchisor will prepare state-specific addenda for many of the states that require registration. In order to be able to use the same form of FDD in the maximum number of jurisdictions, all of the state-specific addenda for the states in which the franchisor registers will be included with each of the registration applications filed.

The 2008 Franchise Registration and Disclosure Guidelines also contain the application pages for filing in the states that require registration. Some states also have additional state-specific forms. During the registration process, some states may provide comments on the documents filed. Depending on timing, this may mean that a franchisor's FDD will not be uniform in all states. If this happens, and it usually does, a franchisor can incorporate the comment responses in the documents prepared once it reaches its first annual renewal

“The FTC Rule provides that states may impose additional disclosure requirements.”

following its next fiscal year end. It can then generate a uniform FDD for filing at that time.

Following are descriptions of fees and filings in the states that require registration.

- *California.*⁶⁵ The application is assigned to an examiner who reviews it for compliance with disclosure requirements and for assessment of the applicant's financial condition. Filing fee: \$675.00; Renewal fee: \$450.00; Amendment fee: \$50.00.
- *Hawaii.*⁶⁶ The application is effective seven days after filing subject to later comments by an examiner. Filing fee: \$125.00; Renewal fee: \$125.00; Amendment fee: \$125.00.
- *Illinois.*⁶⁷ The application is first reviewed to assess the financial condition of the applicant and then, once any comments are addressed, the complete FDD is reviewed for compliance with disclosure requirements. Amendments and renewal filings are effective upon receipt, subject to later comments by an examiner. Filing fee: \$500.00; Renewal fee: \$100.00; Amendment fee: \$100.00 (non-material amendment \$25.00).
- *Indiana.*⁶⁸ The application forms and FDD must be filed, but the registration is effective upon receipt and no review is conducted. Therefore, Indiana is referred to as a “notice” filing state. No amendment filings are necessary. Filing fee: \$500.00; Renewal fee: \$250.00.

⁶⁵ CA Corp. Code §§31000 *et seq.*

⁶⁶ Haw. Rev. Stat. §§482E-1 *et seq.*

⁶⁷ IL Comp. Stat. §§705/1 *et seq.*

⁶⁸ IN Code §1 *et seq.*

⁶³ See Note 39 above.

⁶⁴ 16 C.F.R. §436.10(b)

- *Maryland.*⁶⁹ The application is assigned to examiner who reviews it for compliance with disclosure requirements and for an assessment of the applicant’s financial condition. Filing fee: \$500.00; Renewal fee: \$250.00; Amendment fee: \$250.00.
- *Michigan.*⁷⁰ The applicant must file a one-page notice which is effective upon receipt. No amendment filings are required unless the information in the notice changes. Michigan does require that the text of Section 27 of the Michigan Franchise Investment Law on void and unenforceable provisions precede the table of contents of the FDD, immediately following the cover pages, along with additional specified language. Filing fee: \$250.00; Renewal fee: \$250.00.
- *Minnesota.*⁷¹ The application is assigned to an examiner who reviews it for compliance with disclosure requirements and to assess the applicant’s financial condition. Filing fee: \$400.00; Renewal fee: \$200.00 (additional \$100.00 if changes material); Amendment fee: \$100.00.
- *New York.*⁷² The application is assigned to an examiner who reviews it for compliance with disclosure requirements and to assess the applicant’s financial condition. Filing fee: \$750.00; Renewal fee: \$150.00; Amendment fee: \$150.00.
- *North Dakota.*⁷³ The application is assigned to and examiner who reviews for it for compliance with disclosure requirements and to assess the applicant’s financial condition. Filing fee: \$250.00; Renewal fee: \$100.00; Amendment fee: \$50.00.
- *Rhode Island.*⁷⁴ The application is assigned to an examiner who reviews it for compliance with disclosure requirements and to assess the applicant’s financial condition. Filing fee: \$600.00; Renewal fee: \$300.00; Amendment fee: \$120.00.
- *South Dakota.*⁷⁵ The application forms and FDD must be filed, but the registration is effective upon receipt and no review is conducted. Therefore, South Dakota is referred to as a “notice” filing state. No amendment filings are necessary. Filing fee: \$500.00; Renewal fee: \$250.00.
- *Virginia.*⁷⁶ The application is assigned to an examiner who reviews it for compliance with disclosure requirements and to assess the franchisor’s financial condition. Under certain circumstances, franchisors may file an optional Affidavit of Compliance form with renewal and amendment applications designating an effectiveness date (which may be upon receipt). Filing fee: \$500.00; Renewal fee: \$250.00; Amendment fee: \$100.00.
- *Washington.*⁷⁷ The application is assigned to an examiner who reviews it for compliance with disclosure requirements and to assess the applicant’s financial condition. Filing fee: \$600.00; Renewal fee: \$100.00; Amendment fee: \$100.00.
- *Wisconsin.*⁷⁸ The application forms and FDD must be filed, but the registration is effective upon receipt and no review is conducted. Therefore, Wisconsin is referred to as a “notice” filing state. No amendment filings are necessary. Filing fee: \$400.00; Renewal fee: \$400.00; Amendment fee: \$200.00.

⁶⁹ Md. Code Ann. §14-201 *et seq.*

⁷⁰ Mich. Comp. Laws §445.501 *et seq.*

⁷¹ Minn. Stat. §80.C01. *et seq.*

⁷² NY Gen. Bus. Law §680 *et seq.*

⁷³ N.D. Cent. Code §51-19-01 *et seq.*

⁷⁴ R.I. Gen. Laws §19-28.1-1 *et seq.*

⁷⁵ S.D. Codified Laws §37-5B-1 *et seq.*

⁷⁶ VA Code Ann. §113.1-557 *et seq.*

⁷⁷ Wash. Rev. Code §19.100.010 *et seq.*

⁷⁸ Wis. Stat. §553.01 *et seq.*

There are also a number of states that regulate the offer and sale of business opportunities. These are referred to as seller-assisted marketing plans in some states. Franchisors typically seek exemptions from the requirements of these laws, some of which require that the franchisor make a filing with the state.⁷⁹ Following are the states in which exemption filings are made:

- *Florida*. A franchisor files an annual exemption notice. Filing fee: \$100.00; Renewal fee: \$100.00.
- *Kentucky*. The exemption requires a one-time filing of the FDD. No filing fee is required.
- *Nebraska*. The exemption requires filing of the FDD but no subsequent filings are required. Filing fee: \$100.00.
- *Texas*. This is a one-page, one-time filing. Filing fee: \$25.00.
- *Utah*. A franchisor files an annual exemption notice. Filing fee: \$100.00; Renewal fee: \$100.00.

In some states, maintaining an effective U.S. federal registration of the franchisor's trademark is key to falling outside the definition of a business opportunity, thus avoiding the disclosure and registration requirements of those laws (See Question 11). In Connecticut, a franchisor will need to make a filing if its trademark was registered after October 1, 1996.

Therefore, a foreign franchisor may have greater concerns with business opportunity laws if it does not have an effective federal trademark registration, because it will be more difficult to find an exclusion or exemption in some states.⁸⁰

In order to avoid having the franchise fall within the definition of a business opportunity in a number of the states, a franchisor must also refrain from making certain representations. In general, they include the following:

- that the franchisee will derive income from the franchised business, or that its investment is protected from loss or that the franchisee can earn a profit
- that the franchisor will refund all or part of the fees paid by the franchisee
- that the franchisee will be provided with retail outlets or accounts
- that there is a market for the goods or services the franchisee will offer

Business opportunity laws also require disclosure and registration, but may also impose additional requirements on sellers, such as the posting of a bond, if the agreement includes certain types of provisions. The consequences for failure to comply with these laws can include damages and rescission (including treble damages in some cases), possible individual liability and even criminal penalties.

“There are also a number of states that regulate the offer and sale of business opportunities [...] Franchisors typically seek exemptions from the requirements of these laws ...”

⁷⁹ Connecticut (if mark was registered after October 1, 1996), Florida, Kentucky, Nebraska, Texas and Utah.

⁸⁰ Connecticut, Georgia, Iowa, Louisiana, Maine, Michigan, North Carolina and South Carolina. In Alaska and Oklahoma, there is also a net worth requirement to claim this exemption. Some of these states permit the exemption if there is a state registered mark.

17. Are there exemptions that might be available at the federal and state level, such as a single trademark license exception if the franchisor were to grant one master franchise or development agreement for the entire U.S.?

The FTC Franchise Rule

There are several exemptions that a franchisor should consider when granting a single agreement to a master franchisee or area developer in the U.S.

- *Large franchisee exemption:* The master franchisee or its parent or affiliate is an entity that has been in business for at least five years and has a net worth of at least \$5,424,500.
- *Large investment exemption:* The master franchisee's initial investment is at least \$1,084,900, excluding any amounts financed by the franchisor and the cost of unimproved land. The master franchisee must sign a separate acknowledgement for this exemption to apply.
- *Low initial payment exemption:* The total required payment (or commitment to make payments) by the master franchisee to the franchisor during the first six months of operation does not exceed \$540.00.⁸¹

“State franchise laws typically require pre-sale disclosure and registration of the franchise offering with a state government authority.”

⁸¹ The FTC has the authority to adjust the size of monetary thresholds every fourth year based upon the Consumer Price Index for all urban consumers published by the Department of Labor. See 16 C.F.R. §436.8(b).

- *Single license exclusion:* Before the FTC Rule was amended in 2007, there was an explicit exclusion for single trademark licenses. The FTC declined to continue to include this in the amended FTC Rule. The FTC pointed out that its intention was not to expand the definition of a franchise, but rather to omit the exclusion because this type of arrangement did not fall within the definition of a franchise. This would lead to the conclusion that not all single grants of licenses fall outside of the definition of a franchise, but only those that do not meet all of the definitional elements of a franchise. Therefore, a franchisor should be wary of assuming that an agreement will be exempt simply because there is only one license granted.

Since the FTC Rule does not require registration of franchise offerings, the effect of falling within an exemption to the FTC Rule is that the franchisor is not required to provide the prospective franchisee with an FDD (unless required by state law). There may be situations in which an exemption under the FTC Rule applies, but there is no applicable exemption under one or more of the states that regulate franchise sales. In such a situation, a foreign franchisor may want to consider carving those states out of the franchise grant and addressing development in them at a later time.

State franchise laws

State franchise laws typically require pre-sale disclosure and registration of the franchise offering with a state government authority. The exemptions adopted by states are not uniform, and may be from registration only with disclosure still required. Other exemptions may be from both disclosure and registration, or may require a more limited disclosure. Following are some general types of state exemptions:

- *Large franchisor exemption:* Most states have a large franchisor exemption that couples a net worth requirement (documented in audited financial statements) with an experience component. The franchisor will be

required to have a net worth but may be able to satisfy this requirement if its parent has the requisite net worth according to audited financial statements, and the subsidiary franchisor has a reduced, but still significant net worth, also based on audited financial statements. This may be problematic if the franchisor or its parent has financial statements audited under a different country's generally accepted accounting principles. (See Question 15). The experience component often includes a requirement to have at least 25 franchisees operating during the past five years, or a requirement that the franchisor must have operated the same business for the past five years. In some states, these elements can be combined during the preceding five-year period.

- *Experienced franchisee exemption:* These exemptions will apply if the franchisee or one of its principals has experience in operating a similar business for a certain period of time. Generally the experience must be within a certain amount of time of the grant of the franchise.
- *Discretionary exemption:* Many of the states that have franchise laws accord the state administrator the power to grant an exemption for transactions which do not fall within the state policy for regulating franchises. Although a state administrator may have this power, it may be difficult to convince the state authority to exercise it. Internal policies may restrict the applicability of this exemption.

Exemptions on the state level may require a filing and payment of a fee. Some of the exemptions require this filing before an offer is made, so a foreign franchisor is best counseled to research the applicability of exemptions before beginning discussions with a potential U.S. master franchisee or area developer.

18. If the franchisor enters into a master franchise arrangement, will it be responsible for its master franchisee's compliance with the FTC Franchise Rule and its production of FDDs? Will the franchisor also be responsible for compliance with all applicable state franchise laws?

Yes. The FTC Rule defines a franchisor as any person who grants a franchise and participates in the franchise relationship. Unless otherwise indicated, a franchisor also means a master franchisee.

As explained in Question 5, there are at least two agreements involved in a master franchise relationship – the master franchise agreement between the franchisor and the master franchisee and the franchise agreement between the master franchisee and the sub-franchisee. These two types of agreements each have their own FDDs: (1) the FDD provided by the franchisor to the master franchisee; and (2) the FDD provided by the master franchisee to the sub-franchisee. The latter FDD must include information about both the master franchisee and, to the extent applicable, about the franchisor.

The franchisor is responsible for the master franchisee's representations in the FDD to sub-franchisees. Therefore, the master development agreement should contain detailed provisions about the responsibility for preparing the FDD, covenants to prepare disclosure that includes all material facts and does not omit to state a fact that would make the disclosure misleading, and an indemnity for failure to do so.

“The franchisor is responsible for the master franchisee's representations in the FDD to sub-franchisees.”

Similarly, state franchise laws also require that disclosure be included for franchisors in sub-franchise offerings.

Typically, information about the franchisor will be included in the following Items of the master franchisee's FDD:

- Item 1 (The Franchisor and any Parents, Predecessors and Affiliates),
- Item 2 (Business Experience),
- Item 3 (Litigation),
- Item 4 (Bankruptcy),
- Item 8 (Restrictions on Sources of Products and Services),
- Item 20 (Outlets and Franchisee Information) and
- Item 21 (Financial Statements).

“The relationship laws are far from uniform, but typically they restrict a franchisor’s ability to terminate the franchise relationship without cause.”

19. What are U.S. franchise relationship laws and will they be applicable to the entire franchise system in the U.S.? What about the relationship between the franchisor and the master franchisee?

There are actually more states that address the relationship between the franchisor and its franchisees than states that regulate the initial offer and sale of franchises. There is no federal law governing relationship issues such as transfer, termination, non-renewal, or dispute resolution provisions. The following states and U.S. territories do have such laws: 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. In some states, such as Virginia, if a state regulates both the offer and sale of franchises and the franchise relationship, the two subjects are addressed in a single law.

The relationship laws are far from uniform, but typically they restrict a franchisor’s ability to terminate the franchise relationship without cause. There will often be a requirement that the franchisor provide notice of a default to the franchisee and offer the franchisee a certain period of time within which to cure the default before the franchisor may terminate the relationship. These periods of time can be quite lengthy. Although there are exceptions from the notice and cure provisions, the exceptions can be limited.

One example is the Minnesota Franchise Law. In addition to requiring good cause for termination, it provides that a franchisor must give the franchisee 90 days’ notice and a description of the default, and allow a 60-day period for cure of that default before terminating or cancelling the contract. There are only three circumstances in which immediate termination is permitted: (1) the franchisee abandons the franchise; (2) the franchisee is convicted of an offense directly related to the franchise business; or (3) the franchisee fails to cure a default which materially harms the goodwill of the franchisee’s

“Before a franchisor can decide not to permit the franchisee to renew the relationship at the end of the initial term of the franchise agreement, it will have to comply with the provisions of any applicable state law.”

mark after receiving 24 hours’ notice to cure. It is easy to imagine situations outside of these three exceptions in which no cure is possible or which could cause possible harm to public safety. Yet, there is no exception to the notice and cure period allowed.

Another area that is frequently the subject of these laws is non-renewal. Before a franchisor can decide not to permit the franchisee to renew the relationship at the end of the initial term of the franchise agreement, it will have to comply with the provisions of any applicable state law. Restrictions can include good cause requirements and notice periods before the non-renewal is effective to allow the franchisee the time to transfer the franchise. The Washington Franchise Protection Act requires a franchisor that refuses to renew to fairly compensate the franchisee for the fair market value of the franchisee’s inventory, supplies, equipment and furnishings purchased from the franchisor, as well as goodwill (even though most franchise agreements include an acknowledgement that goodwill associated with the franchisor’s trademarks and system belongs to the franchisor). The franchisor can avoid compensating the franchisee for goodwill by giving the franchisee one year’s advance notice of nonrenewal and by agreeing not to enforce any post-termination covenant against competition.

Franchise relationship laws can also address a long list of other aspects of the franchise relationship including the right of a franchisee to associate with other franchisees and to form a franchisee association, the location and governing law for dispute resolution, competition by the franchisor and discriminatory actions by the franchisor in dealing with its franchisees.

The scope of franchise relationship laws can be quite broad and can cover more than franchise arrangements. For example, some apply to non-

franchise distributor or dealership relationships. If a franchise relationship law is incorporated into the state’s general franchise law regulating offers and sales, the definition and scope of application will be the same. Even in states such as California in which two different laws regulate offers and sales on the one hand, and the franchise relationship on the other hand, the scope of arrangements covered is typically the same. In jurisdictions in which no law governs franchise offers and sales, the definition of a franchise may be different from that which is generally considered a franchise for other purposes, and exemptions may be fewer. The Connecticut Franchises Law, for example, does not require the payment of a fee for a relationship to be a franchise. There need only be a substantial association with the franchisor’s trademark or commercial symbol and a marketing plan prescribed in substantial part by the franchisor.

Remedies under these laws vary as well. They range from the requirement that the franchisor repurchase resalable inventory under the California Franchise Relations Act to treble damages and injunctive relief under the Arkansas Franchise Practices Act, and may include statutory attorney’s fees.

A foreign franchisor should be aware that these prohibitions will apply not only to any master franchisee-sub-franchisee relationship, but also to its own relationship with its master franchisee.

20. This is all too complicated and costly. Why can't the franchisor simply license its program in the U.S. instead of granting a franchise?

This is a question that comes up frequently in the U.S. domestic context as well as internationally. A franchise relationship will almost always involve the license to use the franchisor's trademark or other commercial symbol. Not all license agreements are necessarily franchises, however. Most often, the result will depend on how the relationship is structured and how much control the licensor will have over the operation of the licensee's business.

For a transaction to be a franchise, all three elements of the definition must be present in the relationship.

- The first element is significant association with the licensor's trademark or commercial symbol.
- The second is the payment of a fee.
- The third element varies, depending on the jurisdiction. Under the FTC Rule, this characteristic is described as significant control over the licensee's operations or significant assistance in such operations. In a number of states that regulate the offer and sale of franchises such as California, this element is described as a marketing plan that is prescribed in substantial part by the licensor. Finally, there are a handful of states that instead require that there be a "community of interest" between the licensor and licensee for a franchise to be present. It is important to note that franchise laws are usually considered to be remedial laws and, therefore, interpreted broadly.

It does not matter what name or designation is given the arrangement, if it includes all of these elements, it is a franchise. On the other hand, if it lacks one, it is not a franchise.

Therefore, if a foreign franchisor wants to enter the U.S. market as a non-franchised licensor, it will need to eliminate either the payment of fees or the significant control or assistance element of the definition.

On its face, it would seem difficult for a foreign franchisor to eliminate the fee element because it is likely in business to make money. However, if all the franchisor does is sell goods to the franchisee for resale, that may qualify as an exception from the fee element if the amount paid is a bona fide wholesale price and if the franchisee is not required to purchase more than a reasonable business person would to maintain an inventory.

This exception does not apply to fees paid for services or for any payments outside of the narrow parameters described above.

That leaves the element of the definition that involves significant assistance/control over the operation of the business (federal standard), or a marketing plan prescribed in substantial part or a "community of interest." Determining whether that element is present is a factual analysis. The marketing plan element of the definition of a franchise has generally been interpreted as being broader than merely providing marketing materials to the licensee. Rather, it could be triggered in any system that involves a multiplicity of outlets that are operated in a manner that would cause the public to assume that they are operated under common ownership. Examples of these types of provisions are the requirement that the licensee comply with requirements contained in an operations manual or according to policies and procedures, territorial allocation, specifications and standards, training and, of course, advertising and marketing assistance.

“... if a foreign franchisor wants to enter the U.S. market as a non-franchised licensor, it will need to eliminate either the payment of fees or the significant control or assistance element of the definition.”

“Even if a licensor decides that it is able to forgo any control beyond that necessary to protect its trademarks, and the relationship falls outside of the franchise laws, it must still address the issues raised by the business opportunity laws ...”

If all the licensor requires is compliance with operational standards necessary to protect the licensor’s ownership of its intellectual property or the value of that intellectual property, it would likely not be enough to trigger this element of the definition.

The community of interest standard is even less well defined and broader in its application. One court has suggested that there are ten factors that will be important to consider in determining whether or not the parties have a community of interest. They are: the duration of the relationship, the extent and nature of the parties’ obligations under their agreement, the percentage of time that the licensee devotes to selling the licensor’s products or service, the percentage of revenue that the licensee receives from the grantor’s services, whether a territory has been granted and whether it is exclusive, the extent and nature of the licensee’s use of the licensor’s marks, the extent and nature of the licensee’s financial investment, the number of personnel that the licensee devotes to selling the licensor’s services, the amount that the licensee spends on advertising the licensor’s services and the type and amount of ancillary services that the licensee provides to consumers that purchase those services.

Even if a licensor decides that it is able to forgo any control beyond that necessary to protect its trademarks, and the relationship falls outside of the franchise laws, it must still address the issues raised by the business opportunity laws described in Question 16. Exemptions available to franchisors will no longer apply. If the licensor is unable to structure its program outside of the definitions of those laws or find a different exemption, it will be faced with a regulatory challenge that is in many ways more onerous than compliance with franchise laws.

CONCLUSION

Any foreign franchisor that is thinking about “taking the leap” will have much to consider given its particular program and structure. Thoughtful planning is key and allocating enough time and resources to consider tax planning, protection of intellectual property, supply chain management, and the regulatory requirements for franchising at both the U.S. state and federal level will be critical. The questions addressed in this paper can serve as a tool for such planning exercises.

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APPENDIX – Federal Trade Commission Franchise Rule FAQ 17

Can financial statements be audited by a Canadian chartered accountant who is unable to state that he or she is an independent certified public accountant? What about other foreign accountants?

Answer: In the view of FTC staff, a Canadian or other foreign accountant or accounting firm may audit financial statements for Franchise Rule purposes if the accountant or accounting firm (1) is registered with the Public Company Accounting Oversight Board (“PCAOB”); and (2) recently audited one or more financial statements that have been filed with and accepted by the SEC.

Discussion: The question arises from Section 436.5(u) of the amended Franchise Rule (Item 21), which provides that each FDD required under the Rule must contain financial statements prepared “according to United States generally accepted accounting principles (GAAP), as revised by any future United States government mandated accounting principles, or as permitted by the Securities and Exchange Commission (SEC).” Further, these financial statements (with a limited exception for those start-up franchisors phasing-in financial statements) “must be audited by an independent certified public accountant (CPA) using generally accepted United States auditing standards (GAAS).”¹

FTC staff do not interpret use of the term “CPA” in the Franchise Rule as permitting only an American CPA to audit financial statements. In staff’s view, the Franchise Rule uses the term “CPA” because typically in the offer of franchises in the United States it is a CPA that audits financial statements. The additional language regarding “generally accepted accounting principles (GAAP), as revised by any future United States government mandated accounting principles, or as permitted by the Securities and Exchange Commission (SEC),” argues for a more expansive interpretation than one that would narrowly allow only an American CPA to audit financial statements.

As indicated in the Rule language quoted above, in considering whether foreign accountants may audit financial statements for Franchise Rule purposes, FTC staff look to comparable federal policies regarding public companies in the securities area. In this regard, the Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board (“PCAOB”), which, among other things, is charged with setting forth and monitoring auditing standards. Section 102 of that Act prohibits accounting firms that are not registered with the PCAOB from preparing or issuing audit reports on U.S. public companies and from participating in such audits. Further, section 106(a) of the Act provides that any non-U.S. public accounting firm that prepares or furnishes an audit report with respect to any U.S. public company is subject to the Board’s rules to the same extent as a U.S. public accounting firm. Therefore, in accordance with Sarbanes-Oxley, FTC staff believe that, at the very least, any foreign accounting firm seeking to audit financial statements for purposes of the Franchise Rule must register with the PCAOB.

Foreign PCAOB registered accountants are subject to the same auditing standards as American PCAOB registered accountants. Under SEC rules, financial statements must be prepared using GAAP (or in accordance with another comprehensive basis of accounting standards, with an audited reconciliation to U.S. GAAP).² In addition, foreign auditors, like their American counterparts, must satisfy independence requirements.³ Foreign accountants are also subject to enforcement actions for any violation of federal securities laws.

In addition to satisfying PCAOB registration requirements and SEC accounting and auditing standards for public companies, foreign accountants wishing to audit financial statements under the Franchise Rule must meet any additional qualifications imposed by the SEC. This includes a review of the foreign accountant’s quality controls, personnel qualifications, knowledge of professional standards, and recent audit performance. This review is typically conducted by a consultant retained by the foreign accounting firm. The foreign accountant must have all filings with the SEC that contain its audit report reviewed by an American or foreign accountant knowledgeable with respect to U.S. GAAP, PCAOB standards and requirements, and SEC rules and regulations. Currently, that

means that the reviewing accounting firm must determine, among other things, that the filings have been prepared using U.S. GAAP and audits have been prepared using U.S. GAAS.⁴ The reviewing accounting firm, however, reviews the filing only and need not perform a complete audit on the reviewed material.

Applying these principles, Commission staff believes that foreign accountants or accounting firms may audit financial statements for Franchise Rule purposes consistent with PCAOB and SEC policies. That means that all foreign accounting firms wishing to prepare audited financials under the Franchise Rule must: (1) be registered with PCAOB; and (2) recently audited one or more financial statements that have been filed and accepted by the SEC.

¹ The Commission staff will look to SEC rules and policies when determining what constitutes “U.S. GAAS.”

² 17 C.F.R. § 210.2-02(b).

³ 17 C.F.R. § 210.2-01.

⁴ Commission staff recognizes that SEC rules and policies may change with respect to what constitutes generally accepted auditing standards. We intend to interpret the Franchise Rule’s accounting, as well as auditing standards, consistent with SEC practice.