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Bringing Foreign Restaurant Franchises to the U.S. Market

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Understand franchise laws; be aware of the traps

The notion that the hottest, most innovative restaurant concepts are homegrown in the U.S. is no longer a given. As U.S. consumers demand more diversity, restaurant concepts originating in other countries and authentic to other cultures are becoming increasingly attractive. This creates enormous opportunity for foreign-grown, franchised restaurant brands to enter the U.S. market. But entry without an understanding of franchise laws can be costly.

The U.S. is one of more than 30 countries that specifically regulate franchising, and has done so since 1979. Also regulated currently in nearly half of the 50 states as well as the nation's capital, franchising in the U.S. is subject to a web of standards arguably the most detailed, complex, and, some insist, the most intrusive of all the countries regulating it.

The Definitional Threshold

Fundamental to the application of the franchise laws is that there be a "franchise." Definitional variations and nuances among the regulatory schemes demand further inquiry if at least one of three key elements is present: 1) association with a trademark, 2) payment of a fee, and 3) the franchisor's exercise of significant control or provision of significant assistance in the operation of the business.

Franchise Sales: The Basics

At the federal level, the franchisor's obligation is, in its purest form, merely a pre-sale disclosure obligation subject to the Federal Trade Commission's (FTC's) rule on *Disclosure Requirements and Prohibitions Concerning Franchising* (the FTC Rule). No registration of the franchisor, the franchise disclosure document (FDD) or the franchise program is required at the federal level, but the FTC Rule applies generally to the offer of franchises where the franchisee resides or the franchised business is

to be conducted in the U.S.

Additionally, 14 states have adopted their own regulations which apply to the offer and sale of franchises where: a) sale activity occurs in the state, b) the franchisee resides in the state, and/or c) the franchised business will be conducted in the state. These regulating states add a pre-sale registration requirement to the FTC Rule's pre-sale disclosure requirement. In some states, registration becomes effective only after an examiner is satisfied that the FDD complies with the state's regulatory requirements. This process can present substantive and logistical challenges when changes to documents are made to comply with state differences.

Four Tips

- ***Reading the disclosure laws is not enough***. The FTC Rule and the various state laws are readily available via the internet, but if you stop there, you won't get a complete picture. For example, most states give the administrator of its laws power to determine how the laws will be implemented. The result is a series of specific regulations that often lead to differing, and sometimes disparate, requirements from state to state. Also, state examiners look for compliance with separate compliance guides—one published by the FTC and one by the North American Securities Administrators Association, Inc. (NASAA). Both NASAA and the FTC staff periodically issue responses to questions regarding the FTC Rule (FAQs). While not binding on the FTC or on the regulating states, these FAQ responses are generally relied upon by state examiners. Finally, judicial interpretations provide critical on-going guidance in the drafting of the FDD and form agreements.

- ***Look for exemptions***. Foreign restaurant franchisors entering the U.S. market typically do so only after establishing themselves and their brands in their home countries and achieving a certain net worth, size, and experience. Their U.S. entry strategy often hinges on seeking master or multi-unit franchisees in the U.S. who themselves have achieved a certain net worth, size, and experience. This information can be important in deciding with which obligations the franchisor must comply. The FTC Rule, for example, provides certain exemptions generally based on the size of the initial investment (the "large franchise"), the size/sophistication of the franchisee (the "sophisticated franchisee"), the size of the franchised business in relation to the revenue generated by the franchisee's other businesses (the "fractional franchise") and the single trademark license. Several regulating states have also adopted exemptions, but there are three critical caveats: first, not all of the exemptions under the FTC Rule are also available under each state's laws; second, the state exemptions typically apply to the obligation to register, not the obligation to provide pre-sale disclosure; and third, the franchisor is often required to file a notice of exemption with the state regulatory body.

- ***Beware of business opportunity laws***. Sometimes franchisors purposefully structure their systems to avoid the reach of the FTC Rule or state franchise laws, usually by eliminating one or more of the elements which define a "franchise." However, in doing so, they find themselves mired in an even more cumbersome set of federal and state regulations applicable to business opportunities, including the FTC's recently adopted Business Opportunity Rule and regulations in 26 different states. Like the franchise laws, most business opportunity laws require, among other things, a pre-sale disclosure, but since there is less