

## ***Franchising in America – Tips for representing franchisors entering the US market***

The US is one of more than 30 countries that specifically regulate franchising in some manner. Regulated at the federal level since 1979 and, currently, in nearly half of the 50 states and the nation's capital, franchising in the US is governed by a web of federal and state laws, regulations and jurisprudence that comprise arguably the most detailed, extensive, complex and, some would say, intrusive regulatory scheme of all the regulating countries. Advising franchisors entering the US market can be challenging, frustrating and fraught with traps for unwary franchisors and their counsel.

### **The Definitional Threshold**

To be captured under the various franchise laws, what is being offered or sold must, of course, be a “franchise” as that term is defined under those laws. Because there are definitional variations within the various regulatory schemes, if what is being offered contains one or more of three key elements, it *might* be considered a “franchise”: (1) association with a trademark, (2) payment by the franchisee of a fee, and (3) the exercise of significant control or provision of significant assistance in the operation of the business. If one or more of these elements is present, further exploration of the definition of a “franchise” under each potentially applicable regulatory scheme is critical as variations and nuances do exist. For example, one or more states’ laws may require the presence of only two of the three elements; the “franchisor” may not actually have to own a mark that it represents it will license or have the means to provide the assistance that it represents it will provide; and whether payment of money constitutes payment of a “fee” might depend on the amount, nature and timing of the payment. In short, the definitional threshold is, in some sense, a moving target – what falls short of being considered a “franchise” under the federal definition, for example, may very well be a “franchise” under one or more of the regulating states’ definitions.

### **Franchise Sales - The Basics**

At the federal level, the Federal Trade Commission's rule on *Disclosure Requirements and Prohibitions Concerning Franchising* (16 CFR Part 436) (the “FTC Rule”) is, in its purest form, a pre-sale disclosure rule. No registration of the franchisor, the disclosure document or the franchise program is required at the federal level, but the FTC Rule applies generally to all franchises offered where either the franchisee resides or the franchised business is to be conducted in the US. The FTC Rule is generally satisfied merely by the franchisor's timely provision to a prospective franchisee of a complete and accurate franchise disclosure document or “FDD.”

Many individual states have adopted their own regulatory schemes which, in addition to the FTC Rule, will apply to transactions that satisfy the jurisdictional requirements of the particular state's laws. Typically, these jurisdictional thresholds include one or more of (a) the offer or sale being made in the state, (b) the franchisee residing in the state, and/or (c) the franchised business being conducted in the state. Some states' laws will only regulate certain aspects of the franchise relationship (most, as

discussed below, focused on the franchisor's ability to terminate or non-renew a franchise). Fourteen states, however, regulate the offer and sale of franchises in their states. Those states, like the FTC Rule, require that the franchisor timely provide the prospective franchisee with a complete and accurate FDD (note, however, that - probably not surprisingly - there is variation in what is considered "timely" and what constitutes a complete and accurate disclosure document). Importantly, those 14 states add to the existing disclosure obligation a requirement to register the FDD prior to offering or selling franchises in the state. In some of the regulating states, registration is effective on filing, but in others, the proposed FDD is reviewed by an examiner and is awarded registration only after the examiner is satisfied that the FDD complies with the state's regulatory requirements. This review process can present both substantive and logistical challenges as changes are made to the documents to comply with state differences and, in some cases, to address the peculiarities of the particular state examiner.

### Five Tips

- ***Reading the disclosure laws is not enough.*** The FTC Rule and the various state disclosure laws are readily available via the internet. Reading and understanding them is a necessary first step, but stopping there will provide an incomplete picture. First, as noted above, some states regulate only the franchise relationship, some regulate only the required pre-sale registration and disclosure obligation, and still others regulate both. Second, like Canada, Australia and many other countries that regulate franchising, the pre-sale registration and disclosure laws in the US are backed by a series of regulations and guidance which must also be reviewed. Most states give the administrator of its laws (typically, the state's Attorney General, Department of Corporations, or Secretary of State) latitude to determine how the state's registration and disclosure laws will be implemented. This has resulted in specific regulations applicable to franchising in that particular state, which may include interpretations of specific provisions of the laws, the requirement to use specific forms, and rules relating to fees and timing of filings. Examination of and familiarity with these regulations is a critical step in the process since they often lead to differing and, sometimes disparate requirements from state to state. Third, preparation of the FDD is aided by a Compliance Guide adopted by the Federal Trade Commission, which administers the FTC Rule (the "Commission"), and by a compliance guide adopted by the North American Securities Administrators Association, Inc. ("NASAA") as a model for states with specific franchise registration and disclosure laws. Both NASAA and the staff at the Commission periodically issue responses to questions posed with respect to the FTC Rule ("FAQs"). Responses to FAQs, while not binding on the Commission or on the regulating states or rising to the level of official revisions to the FTC Rule or state regulations, are generally relied upon by state examiners when reviewing FDDs for registration in their respective states. Finally, judicial interpretations of both the FTC Rule and the various state requirements will provide critical on-going guidance in the drafting of FDDs and form agreements used by the franchisor.

- ***Look for Exemptions.*** Though not always the case, franchisors who are stepping into international development are often doing so only after having established themselves, with some degree of success, in their home countries either by operating their own units or having a history of having granted franchises. Anecdotally, this appears lately to be much more the case with in-bound

franchisors than with out-bound franchisors, but it often means that the foreign franchisor has attained a certain size or experience and is seeking master franchisees or area developers that are also of a certain size and experience. This information can be important in deciding with which obligations the franchisor must comply. The FTC Rule does provide for 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 differences: first, not all of the exempt categories under the FTC Rule are also exempt under each state’s laws; second, the exemption typically applies 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 special industry laws.*** Depending on the nature of the franchised business, there might be laws applicable to that specific industry that would apply, either in place of or in addition to the FTC Rule or state disclosure laws. For example, the FTC Rule has a specific exemption that applies to gasoline station franchises where the petroleum marketers and resellers are covered by the Petroleum Marketing Practices Act. Various states have also adopted other special industry laws relating to franchises ranging from beer distributors to farm equipment distributors to automobile sellers. Typically these special industry laws are relationship statutes, regulating the franchisor’s ability to terminate or refuse to renew the franchise, but if the franchise system at issue is in one of these “special industries,” it will be critically important to become familiar with these special industry laws.

- ***Beware of business opportunity laws.*** At times, franchisors will attempt to structure their systems such that they fall outside the reach of the FTC Rule or state franchise laws, usually by eliminating one or more of the elements which define a “franchise” as discussed above. However, in doing so, they typically find themselves mired in what could be an even more cumbersome scheme regulating the offer and sale of business opportunities both under the Federal Trade Commission’s recently adopted Business Opportunity Rule (16 CFR Part 437) and under 26 different state regulations pertaining to the offer and sale of business opportunities. Of the 26 business opportunity states, 10 are among the states that also regulate franchises, and their franchise registration and disclosure obligations will control. The remaining 16 states provide exemptions where (a) the business opportunity involves a licensed trademark (in most, but not all cases, the trademark registration must be a federal, not a state, registration), and (b) the seller of the business opportunity complies with the pre-sale disclosure obligations under the FTC Rule. Given the exemption, most franchisors with a federally registered trademark need not be concerned with the business opportunity laws. These laws are important, however, in a couple of respects. First, some states require either a one-time (Texas, for example) or an annual (Florida, for example) notice filing with a designated state agency. Second, if they apply, the business opportunity states would generally require the business opportunity seller to register with the state, provide prospective purchasers with a pre-sale disclosure document, and, in

some cases, post a bond with the designated state agency. Notably, unlike the state franchise laws, the various business opportunity laws do not necessarily have the same degree of consistency from state to state, making it difficult, if not impossible, to create one multi-state document that would work for all business opportunity states as is possible under the franchise regulatory schemes.

- ***Be mindful of the requirement to update registrations and disclosure documents.*** Franchisors are generally required to update their registrations and FDDs on an annual basis and sooner in the event of the occurrence of a material event. Under the FTC Rule, franchisors are required to update to capture material events on a calendar quarterly basis and to complete their annual renewal within 120 days following the end of their fiscal year. The regulating states have similar requirements, but the varying speeds at which they have revised their regulatory schemes to be consistent with the FTC Rule have resulted in a patchwork of obligations requiring franchisors to capture material events in some states as soon as a “reasonable time” or a specified number of days (30 days, for example) after the occurrence of a material event and to renew their state filings within 90 days following the end of their fiscal year. How important these requirements are will depend, in large part, on how the franchisor approaches development in the US. Franchisors in the US are under no continuing obligation to provide an existing franchisee with an updated FDD, so for franchisors who grant to a single master franchisee the rights to all of the US, this may be a non-issue, at least until a transfer or renewal of the agreement which, in either case, is conditioned upon the execution of the franchisor’s then-current form of agreement. On the other hand, if the franchisor is granting one or more area development deals where each unit would be subject to an individual franchise agreement signed by the franchisor and franchisee as the unit is being developed, the execution of each new franchise agreement will be considered the grant of a new franchise subject to all requirements applicable thereto, thus requiring the franchisor to maintain a current registration and FDD.

## Conclusion

Given the size of the market and Americans’ general acceptance of franchising as a method of distribution, the US presents tremendous opportunities for foreign franchisors despite what might appear to be an overly competitive and highly developed landscape. Taking advantage of those opportunities will require that franchisors and their counsel be familiar with and work within the web of intricate laws and regulations created by a two-tiered regulatory scheme - daunting, but definitely doable and, with the right approach, worth the effort.

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