

Franchising in the US

Compliance with the US franchise laws is costly and burdensome for any company that offers franchises in the US. Franchising is regulated in the US by the Federal Trade Commission (the 'FTC') and by several states. Because of the complexity of these regulations, conducting a franchise programme in the US requires a great deal of advance planning and continued monitoring.

This article gives a brief overview of the franchise laws in the US, some ways in which they might be avoided and what compliance entails. It does not cover such related areas as trademarks or antitrust, corporation or tax laws, all of which will also come into play in the planning of a franchise system.

Overview of the franchise laws

There are two types of franchise laws in the US, both of which are intended to protect franchisees. One type of law requires disclosure and, in some states, registration with a state agency. The second type of law regulates the relationship between franchisors and franchisees, sometimes prohibiting termination by the franchisor except for good cause.

The FTC rule

The FTC trade regulation rule on franchising (the 'FTC rule' or the 'rule') is a disclosure rule and does not require registration or filing. The rule, which became effective in 1979, applies in all states, regardless of whether state laws also apply. Under the rule, everyone offering or selling a franchise must deliver an offering circular to the prospective franchisee at least ten business days before any agreement is signed or any money is paid.

A 'franchise' exists for purposes of the

'Violation of the FTC rule may result in... penalties of up to \$10,000 per day.'

FTC rule if three characteristics are present: (i) operating under the franchisor's trademark or service mark or distributing goods or services associated with the franchisor's trademark or service mark; (ii) exercise by the franchisor of significant control over the franchisee or the provision by the franchisor of significant assistance to the franchisee in its method of operation; and (iii) payment by the franchisee of a franchise fee.

The trademark element will be satisfied if the franchisee does business under the

by Thomas M Pitegoff, Hunton & Williams, New York

franchisor's mark or name, or if the goods or services sold are identified by the franchisor's trademark or service mark. There is no need for a licence or grant of trademark rights.

Examples of significant control include approval of the location of the franchisee's business, requirements regarding site design or appearance, hours of operation, restrictions on customers and sales areas and required participation in promotional campaigns. Examples of significant assistance include training programmes, accounting systems, management, marketing or personnel advice, selecting site locations and furnishing a detailed operating manual.

The third element is a payment to the franchisor or an affiliate of the franchisor as a condition of obtaining or commencing the franchise operation. This payment does not have to be in the form of a franchise fee or royalties on sales. It may be a required payment for advertising assistance, equipment and supplies, training or other items. It does not include payments at *bona fide* wholesale prices for reasonable amounts of merchandise to be used for resale.

State registration laws

The following 14 states have laws requiring the registration or filing by the franchisor of an offer to sell franchises: California; Hawaii; Illinois; Indiana; Maryland; Michigan; Minnesota; New York; North Dakota; Rhode Island; South Dakota; Virginia; Washington; and Wisconsin. In addition, Oregon requires disclosure and Texas has a broad business opportunity law that exempts franchise sales but requires a notice to the state in many cases.

Like the FTC rule, most state franchise definitions also have trademark and fee elements. But instead of significant control or assistance, the state laws require either (i) a grant of the right to engage in business under a marketing plan or system prescribed in substantial part by the franchisor, or (ii) a community of interest between the franchisor and franchisee in the marketing of the goods or services.

Generally speaking, a marketing plan will exist whenever the franchisor presents a group of outlets to the public as a unit, with the appearance of some centralised management and uniform standards. This might be done, for example, through advertising by the franchisor, requirements

regarding site selection, appearance of the premises, uniforms, hours of operation, limitations on products or services or customers, providing training, requiring approval of advertising and signage or the use of an operations manual.

The community of interest element is far broader than the marketing plan element. Any ongoing seller-buyer relationship may satisfy this element.

State relationship laws

The following 18 states have substantive laws governing the relationship between franchisors and franchisees: Arkansas; California; Connecticut; Delaware; Hawaii; Illinois; Indiana; Maryland; Minnesota; Mississippi; Missouri; Montana; Nebraska; New Jersey; South Dakota; Virginia; Washington; and Wisconsin.

'A common approach is to direct potential franchisees to existing franchisees.'

In some states, such as Wisconsin and New Jersey, a franchisor may not be permitted to terminate or fail to renew the franchise agreement without good cause. These non-termination laws are sometimes so broad that they also cover many simple distribution arrangements as well as franchises.

In addition to termination and non-renewal, some of these laws cover such subjects as discrimination between franchisees, free association among franchisees and the situs for litigation or arbitration.

Business opportunity laws

The FTC and 22 states have laws or regulations dealing with 'business opportunities'. These laws generally require registration or disclosure where the seller of the 'business opportunity' makes certain representations or promises to the buyer, such as undertaking to provide locations; to purchase the buyer's products; to refund the purchase price; or to guarantee income in excess of the buyer's investment.

The definition of 'business opportunity' is often so broad that it may cover franchises. However, franchises offered in compliance with state franchise laws and franchises that include the licence of a federally registered trademark or service mark are generally exempt from these laws.

Penalties

Violation of the FTC rule may result in an FTC action for injunction, a cease and

desist order and penalties of up to \$10,000 per day. While there is no private right of action under the FTC rule, violation of the FTC rule may give rise to a private right of action under the 'little FTC acts' of some states. Failure to comply with state registration and disclosure laws may also give rise to an action by the franchisee for damages and for rescission of the franchise agreement.

Avoiding the franchise laws

Jurisdictional scope

The FTC rule extends to the maximum jurisdictional reach of the FTC. It is possible that the rule would apply even if the franchisor and franchisee are both foreigners and the negotiations and contract signing take place abroad, if the franchisee's business is to be located in the US.

Also, a franchisor cannot always avoid the application of the state franchise laws by offering franchises in states other than those that have such laws. If the franchisor is a US subsidiary of a foreign company, the franchise laws of the state in which the subsidiary's office is located may also apply. In addition, if the offer is made to a franchisee in a state other than the one in which his business is to be conducted,

'... a franchisor may not be permitted to terminate or fail to renew the franchise agreement without good cause.'

the laws of that state may apply. Sometimes, the laws of two or more states apply to the same transaction.

The jurisdictional scope of the franchise laws varies from state to state, and the franchisor must look carefully at the scope of each law that might conceivably apply.

Avoiding the FTC rule

The franchisor might be able to avoid the application of the FTC rule by structuring the arrangement so that it does not fall within the FTC's definition of a 'franchise'. For this purpose the payment element is the most promising aspect of the FTC rule. The rule specifically exempts minimal investments. If the franchisee is not required to pay at least \$500 during a period from any time before to within six months after commencing operation of the franchisee's business, the FTC rule will not apply.

The franchisor can simply charge no initial fee and waive royalties for the first six months. Even a commitment entered into at the outset that requires a payment later than six months after commencing operation is not counted toward the \$500 minimum. For example, a promissory note that is not payable until after this six month period would not be a required payment for purposes of the FTC rule.

Exemptions under the state laws

Unlike the FTC rule, there is no exemption

under the state registration and disclosure laws for minimal investments. In fact, the Virginia franchise registration law is applicable without regard to the payment of a franchise fee. Therefore, exemption under the FTC rule for lack of any required payment in the first six months will not avoid the requirement to register or disclose in those states requiring registration or disclosure. (The FTC's minimal investment exemption is nevertheless helpful if the franchisor is testing the market in one or more states that do not require registration or disclosure.)

Some states do have exemptions not found in the FTC rule. One is the exemption for an offer or sale by a franchisor with a large net worth and significant franchising experience. In California, for example, a franchisor is exempt if it has the requisite experience and a net worth of at least \$5 million. In New York, such a large franchisor may apply for an exemption, which is automatic only if the franchisor has a \$15 million net worth.

Some states also exempt limited offers. New York exempts an offer directed to not more than two persons, provided that the prospective franchisee does not have the right to offer franchises to others, no remuneration is given for soliciting a prospective franchisee, and the non-resident franchisor has consented to service of process. The state of Washington exempts offers to fewer than ten franchisees where the offers are not advertised through any medium in the state.

An exemption under a state franchise law may relieve the franchisor from the requirement to file or register. It will not always relieve the franchisor of the disclosure or substantive obligations under state law. Also, exemption under a state law does not necessarily mean the franchisor is exempt from the disclosure requirements of the FTC rule.

Compliance

The offering circular

If the franchisor decides to offer franchises in a manner within the scope of the federal or state disclosure requirements, the franchisor must prepare a franchise offering circular.

The offering circular must contain, among other things, a detailed explanation of the prospective franchisee's rights and obligations under the franchise agreement; information regarding the directors and principal officers of the franchisor; and the litigation and bankruptcy history of the franchisor. The circular must also contain financial statements of the franchisor and copies of all agreements the franchisee may be asked to sign.

For some companies, the desire to keep some of this information confidential will be reason enough not to franchise in the US.

FTC v UFOC format

Two offering circular formats have been

developed, one by the FTC and one by the Midwest Securities Commissioners Association, the latter called the Uniform Franchise Offering Circular, or more commonly the 'UFOC'. For most franchisors, the differences between the disclosure requirements of the FTC and UFOC are not significant. However, the UFOC will satisfy the FTC requirements, and some states will accept only the UFOC. For this reason, most franchisors use the UFOC format.

Financial statements

Whichever format is used, the offering circular must also contain audited financial statements of the franchisor for the last three years, prepared in accordance with generally accepted accounting principles of

'The franchisor can simply charge no initial fee and waive royalties for the first six months.'

the US. This is one area that can cause particular problems for non-US franchisors.

The FTC requires that audited statements be prepared as soon as practicable, but will accept unaudited statements prepared in accordance with US accounting principles for years prior to the first year of compliance. While the FTC will accept phased in audits, the UFOC requires that all financials be audited except those as of a date within 90 days prior to the application for registration.

As a practical matter, a new non-US franchisor may have no choice but to use unaudited financial statements for the initial circular, regardless of which format is used. The franchisor will have to explain to the state examiner in each case why it was not able to provide audited financials, and the failure to use audited financials may cause a delay in registration in some cases.

The requirement to provide audited financial statements each year prepared in accordance with US accounting principles may be the deciding factor for some companies not to franchise in the US.

Timing the initial offering

Registration states generally require that the financial statements be current to within 90 days prior to the date of the filing. In order to avoid the requirement of preparing interim financials in these states, the franchisor must file within 90 days after the end of its fiscal year. After the franchisor has filed in a registration state it can take several weeks, or even months, before the state grants its approval. During this period, the franchisor may not offer franchises in such states.

Substantive requirements of disclosure laws

The registration and disclosure laws have a substantive component. They regulate the timing of the disclosures, they may for-



bid negotiation and they may require that the franchise agreement contain or not contain certain provisions.

A franchisor cannot advertise its offering of franchises in a registration state until it is registered in that state. Most registration states also require franchisors to file advertisements and other materials used to recruit franchisees. Some states require approval of the materials before they can be used.

State regulators evaluate, among other things, the adequacy of a franchisor's capitalisation to be sure that the franchisor can meet its obligations. If the franchisor is undercapitalised, the state may require the franchisor to place all franchise fees in escrow, or it may require a surety bond or require a parent company to file its own audited financial statements and guarantee the performance of the subsidiary's obligations.

The state can also deny registration altogether, and with it the right to offer franchises in the state.

Earnings claims

If the franchisor makes any oral or written representations about actual or potential sales, expenses or profits of the franchisee, the franchisor will be required to deliver to the prospective franchisee an earnings claim document with substantiating

material. An earnings claim is any suggestion of a specific level or range of historical, potential or actual sales or profits.

Most franchisors do not make earnings claims because of the cost of preparing the substantiating material and the potential liability for incorrect claims. A common approach is to direct potential franchisees to existing franchisees. Some franchisors, however, may prefer to make earnings claims in a controlled manner rather than risk that their salespersons will make unauthorised claims.

Compliance programme

Ongoing franchise compliance requirements extend beyond the annual preparation of audited financial statements. The franchisor must monitor, among other things, the timing of the delivery of the offering circulars and agreements to prospective franchisees and the obtaining of signed and notarised acknowledgements of receipt from prospective franchisees.

The franchisor must also monitor the expiration and renewal of state registrations, which are usually effective for one year. In addition, the franchisor must monitor which changes require amendment to the circular and ensure that unauthorised claims or commitments are not made.

Different circulars will have to be used

for certain states, and the franchise sales person must know in each case which circular to use and in which states offers may not be made. Occasionally, more than one state will require disclosures in the same transaction.

The future

What are the prospects for the future? The National Council of Commissioners on Uniform State Laws recently proposed a 'Uniform Franchise and Business Opportunities Act', which is soon to be proposed in the legislatures of the 50 states. The fear among many franchise lawyers is that this 'uniform Act' will be adopted piecemeal by the state legislatures. States that do not now have franchise laws may adopt some variation of the uniform Act, and states that already have franchise laws either may not adopt the Act, or may adopt only parts of it. The expected result is that the US will have a more onerous patchwork quilt of regulation than it has today.

Terry Calvani, one of the five commissioners of the FTC, has raised the possibility that the FTC might pre-empt state franchise laws altogether. However, for the foreseeable future, franchise regulation in the US is likely to remain complicated, costly and burdensome. ■