

**Entering the U.S. Franchise Market:  
An Overview of Laws Effecting Franchising in the U.S.**

By

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## **Introduction**

### **a. The Speaker**

Over the course of an 18-year legal career, Tim Pickwell has represented some of the biggest names in the franchise and restaurant industry—and some of the smallest. He gained his initial franchise experience negotiating international license agreements for 6,000 unit franchisor CENTURY 21® Real Estate (1988-1994). He then headed up the international franchise division of \$2.2 billion revenue, publicly-traded JACK IN THE BOX® Restaurants (1995-2000), and served as corporate counsel to its purchasing, IT and marketing departments. From 2000-02 Mr. Pickwell was general counsel of a Silicon Valley-based pre-IPO telecommunications start-up, and also represented several other start-up and telecommunication companies. More recently, Mr. Pickwell served as General Counsel (2002-05) to the Coco's® and Carrows® restaurant chains, where, among other things, he supervised franchise sales and operations.

Mr. Pickwell's unique in-house background enables him to provide practical, business-oriented solutions to franchisors and franchisees. His expertise includes intellectual property licensing and trademark matters, international franchising, retail lease drafting and negotiations, franchise registration and compliance, litigation advice, and general corporate and business matters. Clientele includes established franchisors, large restaurant companies, multi-unit franchisee organizations, as well as single-site retailers, and start-up franchisors. Mr. Pickwell is a member of the California Bar, and is admitted to the Federal District Courts for the Northern, Central and Southern Districts of California. Mr. Pickwell is an Honors Graduate of the University of California, San Diego, and obtained his J.D. from the University of California, Hastings College of the Law. He resides in North San Diego County with his wife and three children.

### **b. The Speech**

This presentation is intended for an audience of business people who have established concepts in other countries, and who are considering entering the United States Market, most likely through franchising.

## **II. Is Franchising the best way to enter the U.S. Market? Alternatives**

### **a. Company-owned Units or Operations**

- i. High degree of control
- ii. Subsidiaries
- iii. Employees
- iv. Tax issues
- v. Employment laws
- vi. Rent
- vii. Insurance

**b. Distributorship for Products**

- i. Limited exposure
- ii. Limited control
- iii. If agreement not drafted properly, you risk being an inadvertent franchise (see, below).

**c. Joint Venture / Partnership**

- i. Shared costs, expenses, risk
- ii. Can control (or not)
- iii. Multiple structures and types.

**d. Franchising**

- i. Relatively limited expense and exposure
- ii. Allows you to take advantage of local knowledge
- iii. Use others' money to expand brand
- iv. Potentially less control
- v. Must adapt system to U.S.
- vi. Relatively complex legal requirements for registration and disclosure.

**III. Franchising Generally**

Franchising is a means of growing a brand by using the proprietary knowledge of the franchisor and the capital and entrepreneurial energy of the franchisee.

**a. Most important issue: Pick the right Partner**

- i. Must share your philosophy for growth, quality, training, etc.
- ii. Identify the core values of your system (e.g., people, customer service, price, food quality, passion for the business, etc.) and find someone who shares your core values.

**b. Pick the right form of franchising**

There are many different ways to franchise. Some concepts lend themselves particularly well to single unit franchising, while others may be better suited for master franchising. There are numerous variations on each them, but these are the three basic types:

- i. Single unit franchising
  - 1. High degree of direct control
  - 2. Direct relationship with franchisee

3. You sell them, train them, monitor them, support them.
4. Can be slower initially; need resources to sell, train and support units.
5. You keep 100% of franchise fees and royalties.

ii. Area Developer

1. Small area (e.g., a county, or part of a city).
2. Right to open a specific number of units (e.g., 5-15 units)
3. Must open on a specified schedule: 1 or 2 per year.
4. Attracts more sophisticated, wealthy franchisees
5. These, in turn, are harder to find.

iii. Master Franchising (often called Sub-Franchising)

1. Grant a master Franchisor the right to sell franchises.
2. Often rapid development
3. Master Franchisor is highly motivated.
4. Takes advantage of local knowledge.
5. Share royalties and franchisee fees with Master Franchisor.
6. This is a different business model than single unit franchising. With Master franchising you are not training or supporting franchisees, you are training and supporting the people who sell and service franchises.

c. Summary

Your system and what you sell / service will dictate the right form. For example, can you train and sell franchises to anyone? (e.g., Subway?) Or, does your franchisee have to be in the industry already, or have a professional license or degree for the service? (e.g., Century 21) Your pace of growth and need to control training, growth, site selection and product quality may also help dictate the type of franchise you offer.

**IV. Legal Considerations**

a. The Contract

- i. There must be a relationship between the contractual structure, the franchise concept, and the contract. Avoid “one-size-fits-all” franchise agreements.
- ii. Spend time with your advisors, businesspeople and consultants ensuring that the type of contract meets your need.

1. For example, do you need a high degree of quality and image control? And thus a “tough” contract with highly specific and detailed control provisions?
  2. Or, are you more focused on sales, and want a simpler, less onerous contract?
- iii. The contract should anticipate and address:
1. Levels of Control by the Franchisor
  2. Quality v. Growth
  3. Infrastructure needed to support the business model.
  4. Fee structure: it must be right for both parties. High initial fees and royalties may look good to the franchisor for a short while, but if the franchisees are not profitable, the system will fail. Conversely, a fee structure that is too low (e.g., a 2% royalty) may not support a franchisor or sub-franchisor).

## **V. Laws Affecting Franchising**

### **a. Franchise disclosure laws**

The go-go franchise sales days of the 1960’s and early 1970’s led to widespread franchise sales fraud—or at least the perception of it. Certain states (notably California), followed by the federal government enacted the first franchise laws. Because many of the people involved were also securities regulators, the laws took a decided shape, and were modeled after securities laws. Thus, the emphasis was on registration and/or disclosure. The general premise being that more information, and more accurate information would benefit franchisees.

This premise holds true today, and colors the judgment of any good franchise attorney: err on the side of disclosing more information.

Fourteen states and the federal government feature franchise disclosure laws, pursuant to which no franchise may legally be offered or sold, no contract signed and no money paid unless the prospective franchisee first receives a comprehensive disclosure document. The Federal Trade Commission (FTC) Franchise Rule mandates disclosure but no registration of the disclosure document is required.

By contrast, all of the states featuring franchise disclosure laws on their books provide an elaborate registration protocol pursuant to which both the franchisor seeking to offer franchises, and the disclosure documents they intend to utilize to do so, are closely scrutinized before any franchise registration is forthcoming.

## **Registration States**

California	New York	Maryland	Virginia
Wisconsin	Illinois	Minnesota	Indiana
North Dakota	South Dakota	Hawaii	Washington
Rhode Island	Michigan (notice only)		

### **i. Federal**

The FTC Rule deals with franchising and business opportunities pursuant to section 5 of the Federal Trade Commission Act. This rule governs the offer and sale of franchises by a franchisor throughout the United States and, under certain circumstances, may govern the sale of franchises internationally.

### **ii. State**

While the states share no uniform franchise disclosure law or even a common definition of the term "franchise," working together under the umbrella of the North American Securities Administrators Association (NSAA) state regulators developed a single disclosure document, the Uniform Franchise Offering Circular ("UFOC"). The UFOC when accompanied by certain addenda, will satisfy the requirements of all franchise registration states and will satisfy the FTC as well.

Each state franchise disclosure law has unique "twists." The scope, terms, provisions and disclosure requirements of each franchise disclosure statute vary and a franchisor engaging in multistate franchising activity must be careful.

The starting point is the state law definition of "franchise." Unfortunately, there is no uniform definition, and thus the scope of coverage of each state statute must be carefully analyzed.

### **iii. What is a franchise? Who is a Franchise?**

#### **1. Definition of a "Franchise"**

The California Franchise Investment Law provides a fairly typical example of the definition of a franchise under state law. Section 31005 of the California Corporation Code defines "franchise" to mean any contract or agreement, either express or implied, oral or written, between two or more persons by which:

- (1) A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and

- (2) The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and
- (3) The franchisee is required to pay, directly or indirectly, a franchise fee.

An analysis of the California definition reveals that five elements must be present for a franchise to exist. These are:

1. There must be a contract between the parties.
2. The franchisee must be granted the right to engage in a business.
3. The franchisee is given a right to use the franchisor's name or mark to identify his business.
4. The franchisee is required to pay something of value to the franchisor.
5. The franchisor prescribes a marketing plan for the franchisee.

## **2. The Inadvertent Franchisor**

Over the past 30 plus years, many a company that is not a "franchisor" in the traditional sense has discovered that its way of doing business, its methods of distributing products or services, or its grant of trademark or other "licenses" brings it within the extraordinarily broad jurisdictional scope of federal and state franchise laws.

This discovery usually takes place in the context of a government investigation or prosecution, often accompanied by private lawsuits commenced by putative franchisees unhappy with the business relationship.

Merely calling oneself a "licensor" or a "distributor" is no protection from the broad reach of the franchise regulators. A court will look to the actual relationship and the state or federal law definition of a franchise, not any helpful declarations of what the relationship is supposed to be.

If a company is not careful, it will find itself subject to the criminal and civil penalties that apply to illegal franchising as always and private rights of action commenced by self-styled "franchisees" unhappy with their business relationship with their clients. Ignorance of the (franchise) law is no excuse.

### **iv. Relationship Laws**

Eighteen states, two territories and the District of Columbia have enacted what are referred to as "franchise relationship" statutes. They are: Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, South Dakota, Virginia, Washington, Wisconsin, the U.S. Virgin Islands and Puerto Rico.

Generally, these state franchise relationship laws govern when, and under what circumstances, a franchisor may terminate or refuse to renew an extant franchise. These laws also address such aspects of the franchise relationship as fair dealing, discriminatory treatment, market protection, encroachment, the ability of franchisees to associate and the minimum advance notice of franchise termination, expiration or nonrenewal that must be given to franchisees.

The provisions of state franchise relationship laws typically supersede the language of the franchise agreement, and determining which states' laws apply can itself be a challenging task.

#### **iv. What must be registered?**

1. Franchise Offering Circular
  - a. Including financials, franchise agreement and exhibits.
2. Advertising Materials
3. Names of Franchise Brokers / Salesmen

#### **b. UFOC**

The Uniform Franchise Offering Circular (“UFOC”) is the basic compliance document for franchise offerings and sales. A properly prepared UFOC, with certain addendum for each state, should satisfy the registration and disclosure requirements of the 14 registration states, or provide for an exemption in states with Business Opportunity Laws, and, finally, will satisfy the FTC requirement.

The UFOC contains twenty three “Items”. Collecting the information for these Items, and compiling the data and information, and putting it in a useable form can require a substantial amount of time and effort.

The Items and what is required are as follows:

#### **Item 1 The Franchisor, Its Predecessors and Affiliates**

All corporate information, including business names, date of incorporation, business address, name(s) of principal stockholders, names of affiliates, and predecessor companies.

*Source:* Corporate books and records.

## **Item 2 Business Experience**

Brief history and background of principal executives running the business.

*Source:* Interviews, resumes, and forms signed by officers.

## **Item 3 Litigation**

Information on any legal proceedings involving the company.

*Source:* Disclosure by franchisor and its outside counsel; legal pleadings.

## **Item 4 Bankruptcy**

Information on whether, during the previous ten (10) years, the company, any predecessors, any affiliates, or any officers have filed for bankruptcy.

*Source:* Corporate books and records, interviews, resumes, and disclosure forms signed by officers.

## **Item 5 Initial Franchise Fee**

Detailed information about the amount of the initial franchise fee, how it may be paid (e.g., terms), refunds, etc.

*Source:* Franchise agreement.

## **Item 6 Other Fees**

Information relating to other fees. For example, (i) on-going royalty, (ii) advertising fund fee; (iii) advertising cooperative fee; (iv) payments for supplies and inventory, etc.

*Source:* Franchise agreement.

## **Item 7 Initial Investment**

Estimated amounts for a typical initial investment. For example, the costs associated with (i) acquisition of property or lease; (ii) construction and remodeling costs; (iii) costs of furnishings, etc.

*Source:* Company experience, contractors, real estate brokers, existing franchisees, estimates by company executives.

## **Item 8 Restrictions on Sources of Products and Services**

An explanation of the obligations of franchisees to purchase certain products or services from the franchisor or its affiliates.

*Source:* Franchise agreement, company executives.

### **Item 9 Franchisee's Obligations**

A description of the franchisee's obligations. For example, their obligation to purchase insurance, indemnify the franchisor, etc.

*Source:* Franchise agreement.

### **Item 10 Financing**

A detailed disclosure of any direct or indirect financing arrangement offered by the franchisor or its affiliates.

*Source:* Franchise agreement; Franchisor.

### **Item 11 Franchisor's Obligations**

A long, narrative explanation of the franchisor's obligations.

*Source:* Franchise agreement, actual experience.

### **Item 12 Territory**

Description of exclusive territory, if any.

*Source:* Franchise agreement.

### **Item 13 Trademarks**

A list of the principles trademarks that will be licensed to the franchisee.

*Source:* Franchisor, franchise agreement, United States Patent & Trademark Office.

### **Item 14 Patents, Copyrights and Proprietary Information**

Similar to 13, but a list of all patents, copyrights and proprietary information to be licensed to the franchisee.

*Source:* Franchisor, franchise agreement, United States Patent & Trademark Office.

**Item 15      Obligation to Participate in the Actual Operation of the Franchise Business**

An explanation of whether the franchisee will be required to be actively involved in the business.

*Source:* Franchise agreement.

**Item 16      Restrictions on What the Franchisee May Sell**

A narrative explanation of restrictions that the franchisor may impose on what franchisees may offer or sell from their franchised units.

*Source:* Franchise agreement; operating manuals.

**Item 17      Renewal, Termination and Dispute Resolution**

A disclosure of franchise provisions relating to renewal, termination and dispute resolution, and what constitutes “for cause” termination, etc.

*Source:* Franchise agreement.

**Item 18      Public Figures**

If a famous person will be involved in promoting the franchise, this must be disclosed in Item 18.

*Source:* Franchisor.

**Item 19      Earnings Claims**

If making an “earnings claim” it must be supported by disclosure in Item 19 of the UFOC. The earnings claims must have a reasonable basis, generally stated as a range or average for similarly situated units.

*Source:* Franchisor.

**Item 20      List of outlets**

A chart showing a state-by-state summary of the status of franchised units for the previous three years (i.e., the number that have entered the system, still open, have exited the system, etc.).

*Source:* Franchisor

## **Item 21 Financial Statements.**

It is necessary to include in your Offering Circular your audited financial statements for the previous three fiscal years. If you have existed for less than three years, you can provide statements from the time of your existence.

Unaudited Financial statements are also required if the franchisor's most recent fiscal year is more than 90 days prior to the filing date. Alternatively, the franchisor's affiliate may file its statements if it "absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor under the franchise agreement."

All financial statements must be prepared in accordance with generally accepted accounting principles ("GAAP"). Moreover, all required financial statements must be presented in a format of columns that compares at least two fiscal years.

### **Foreign Corporations**

Due to the requirement that financial statements be prepared and presented in accordance with U.S. GAAP, most foreign franchisors establish U.S. subsidiaries to be the franchisor of their systems in the U.S. This may have other undesirable consequences, such as limits on the length of time for which the franchisor can report the results of its operations, the imposition of U.S. taxes and so on.

*Source:* Franchisor, CPA Firm.

## **Item 22 Contracts**

A list of all agreements or contracts that will be executed with the franchisee.

*Source:* Franchisor, franchise agreement.

## **Item 23 Receipt**

### **c. Penalties for Non-Compliance**

Failing to comply with federal and state franchise disclosure statutes yields grave results. Any failure to register any fraudulent or unlawful activity engaged in, any intentional making of an untrue statement of a material fact, any act which would or does operate as a fraud or deceit and any attempt to compel franchisee waiver of any given statute's protections are, under most of the laws, declared fraudulent and unlawful practices. Each violation of the FTC Franchise Rule-that is, each franchise sold absent any disclosure document whatsoever or pursuant to a fraudulent or misleading disclosure document-is punishable by a fine of \$11,000.

State disclosure laws confer upon franchise administrators broad powers to investigate franchise sales fraud and, institute both criminal and civil proceedings seeking restitution, rescission, damages, injunctions, fines and court-ordered receiverships. Many

state franchise administrators possess "stop order" powers, the ability to suspend *ex parte* a franchisor's franchise registration, and thus its ability to offer and sell franchises, should the administrator believe that fraudulent or illegal activity is being engaged in. Finally, most state franchise disclosure laws confer upon franchisees a private right of action for rescission, damages and attorney fees.

### **Officers and Directors Personally Liable**

Under most state franchise disclosure statutes, the franchisor, its officers, directors and senior managers are subject to both criminal and civil liability for violations.

#### **d. Exemptions**

Both the FTC Franchise Rule and virtually all of the state franchise disclosure laws contain a series of exemptions from their coverage. The key federal exemption applies to a "fractional franchise" [where a franchisee, or one of its directors or executive officers, has been in the type of business represented by the franchise for more than two years and the parties anticipate that the gross revenues attributable to the franchise will represent no more than 20% of the total gross revenues of the business received in the franchise]. The most common exemptions from state franchise disclosure law registration requirements pertain to large franchisors [those featuring a certain net worth and, in certain states, a certain number of franchisees that have been operational for a specified period of time].

Some states afford exemptions when the franchisees at issue are deemed "sophisticated franchisees" [under statutory tests that vary from jurisdiction to jurisdiction]. Almost all states exempt the isolated sale of a franchise effected by a franchisee for his/her/its own account. More and more states are adopting the FTC's "fractional franchise" exemption. And the sale of an additional franchise to an existing franchisee is exempt under the FTC Franchise Rule and many state franchise laws, but only when the new franchise is granted on terms not materially different from the franchisee's existing agreement.

Even if an exemption from registration and/or disclosure is available under state franchise disclosure statutes, the FTC Franchise Rule will usually require disclosure nevertheless.

Disclosure is always a good idea.

#### **e. On-going Annual Registration**

Registering to offer and sell franchises is not typically a one-time thing. A franchisor must update and renew its filing each year, including providing new financials. Additionally, a franchisor is typically required to register a new offering when there has been a material change in any of its information. While the new registration is pending, the franchisor is often prohibited from offering or selling franchises. However, under the FTC rule, covering non franchise regulating states, the disclosure document can be changed and immediately used since no registration requirement exists.

## **VI. Life Cycle of a Franchisor in the United States**

**STEP 1** Develop business concept and model that are profitable at **unit** level

Notable Failures: Koo Koo Roo; Boston Market

**STEP 2** Register Trademark

Examples: Azteca had to become Qdoba

Downsides: No exemption from state business opportunity laws

**STEP 3** Develop Franchise Contract and Manuals

**STEP 4** Develop UFOC

Critical issue: Audited Financial Statements. Plan ahead to have your financial house in order for a clean audit.

**STEP 5** Sell Franchises

Different Approaches: Business brokers; employees on staff.

**STEP 6** Train Franchisees / Build Units

Will they come to your headquarters? Or, will a team go to them? Will it take 2 weeks? A month? 13 weeks?

**STEP 7** Collect Royalties

Examples: More franchisors are dictating the type of POS system that retail franchisees can use, and are processing credit cards or other payments in order to collect fees and royalties off the top.

**STEP 8** Manage Database Internally

To ensure compliance with myriad state and federal laws, you must track your franchise agreements, deadlines, dates, registrations, and keep well-organized files of all communications and notices to franchisees.

**STEP 9** Franchise Councils and Conventions

Manage the process. The franchisees will talk, You should be a part of the conversation. Franchisees are a good source of ideas.

**STEP 10** Growth, Advertising, New Products

At some point, you must convert from selling franchises to selling products or services. Franchisees have to make a profit.

**STEP 11** Terminations

At some point you will have to enforce standards and weed-out the handful of franchisees who shouldn't be in the system. To minimize legal problems, you must demonstrate fair, objective, evenly applied criteria that are defined in the franchise agreement and manuals.

**STEP 12** Renewals, Assignments, Sales in a Mature System

There is always turnover in a franchise system as weak franchisees fail, successful franchisees cash-out, or people get ill, die or want to transfer the business to family members. Managing the renewal, assignment and re-sale process can be critical to ensuring that you control the quality of franchisee entering your system.

**VII. Summary**

Done properly, with a methodical approach, franchising can be a successful expansion strategy throughout the United States. But, the start-up franchisor needs to be mindful of Federal and State franchise regulations, and invest the time and money in ensuring that its business model and contracts are mutually supportive and that both comply with the law.