Amended U.S. Franchise Rule Breaks Down Barriers to Entering U.S. Market

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Despite being the oldest and most lucrative market for franchising, very few franchisors from other countries have set up operations in the U.S. Why? Many believe the reason is the costs which U.S. franchise sales laws have imposed on franchisors. Even though U.S. franchise laws apply the same rules to domestic and foreign franchisors, the cost of compliance has been disproportionately harsh on Canadian franchisors coming to the U.S. Many of those barriers to entering the U.S. franchising market are about to fall. As of July 1, 2007, when long awaited amendments to the Federal Trade Commission's Franchising Trade Regulate Rule ("FTC Rule") become effective, the rules of the game will change, and franchisors based outside the U.S. will be the biggest beneficiaries of the changes.

UFOC Not Needed Before Meeting with Prospective Franchisees

The change with the greatest impact is likely to be the elimination of the requirement that franchisors provide prospective franchisees with a Uniform Franchise Offering Circular ("UFOC") at the first serious face to face meeting conducted to discuss the possible sale of a franchise. That has meant that, regardless of the degree of potential interest of either an American franchisee prospect, or a Canadian franchisor who is interested in testing the American market, the Canadian franchisor could not conduct in person discussions with the prospect without investing \$20,000-\$30,000 USD in legal and accounting fees to meet the FTC's presale disclosure requirements.

New Exemptions Allow Some Franchisors to Avoid Disclosure Obligations

Even better, the FTC has added three new exemptions to the FTC Rule, which will entirely eliminate the need for UFOC disclosures in many transactions. One exemption applies to transactions in which a franchisee will invest at least \$1 million USD, excluding unimproved real property and amounts financed by a franchisor. Canadian franchisors using multi-unit franchising strategies, such as area development franchising or master franchising may have little problem meeting this threshold, and avoiding the Rule's disclosure requirements.

A second exemption is available if a franchise is granted to a company which has been in business for at least five years and has a net worth of at least \$5 million USD. Canadian franchisors looking for franchise partners which are established businesses may really like this exemption.

A third exemption applies to the grant of a franchise to a franchisee which is at least 50% owned by an owner, "officer, director general partner or individual with management responsibility of the offer and sale of the franchisor's franchises or an administrator of the franchised network." A Canadian franchisor could dispatch such a person to the U.S. to set up a business with local investors, use it as a prototype unit to test and adopt the concept, and avoid FTC disclosures.

Compliance with New Disclosure Requirements Is Easier

The first personal meeting disclosure requirement has been only one of the obstacles faced by Canadian franchisors. Adding to the frustration of Canadian franchisors has been the need, under current FTC requirements, to spend money on market research to prepare reasonably accurate estimates of the initial investment their American prospective franchisees would incur. Without market research, making estimates of costs in the American market has been very difficult for Canadian franchisors. Besides fronting market research cost, Canadian franchisors have incurred fees for three years of the franchisor's audited financial statements which must be included in UFOCs. Those statements must comply with U.S. auditing standards, rather than the Canadian standards. For some companies, especially large, publicly traded companies, that requirement has often been the straw which has broken the camel's back, and they have deferred exploring U.S. franchise opportunities. The Amended Rule reduces those burdens in several ways.

If a Canadian franchisor does find a prospective franchisee and decides to award a franchise, even if an exemption from the Rule is not available, the franchisor will be able to work with the franchisee, who presumably has knowledge of his local market, to prepare the initial franchisee investment estimates the Rule requires. The preparation of the U.S. estimates can be based on the market where the prospective franchisee resides, and working with the prospect on these issues will allow the Canadian franchisor to better evaluate the qualifications of the prospect.

The Amended Rule relaxes the requirement that all financial statements used in a UFOC must meet U.S. Generally Accepted Accounting Principles (GAAP), by allowing use of financial statements which meet the standards of the franchisor's home country, so long as they can be reconciled to U.S. GAAP, and include any additional disclosures required by U.S. GAAP and U.S. securities laws. Thus, a Canadian franchisor may be able to modify its existing financial statements to meet the Rule's new standards, without going to the expense of a new U.S. audit of its last three years of operation.

A Canadian franchisor may be able to avoid an audit altogether during the first year it franchises in the U.S. and phase in to the requirement to include three years of audited financial statements in its disclosure document. Companies "new to franchising" which have not previously "prepared audited financial statements in the ordinary course of business" need not have an audit during their first fiscal year of franchising, and may phase in to the requirement to have three full years of audited financial statements in their UFOCs. A Canadian company which has neither granted franchises in the U.S. nor had its financial statements prepared under U.S. GAAP should qualify for the phase-in treatment. That point should be clarified in compliance guidelines the FTC plans to publish by April.

Electronic Delivery of UFOCs Allowed

Until the Amended Rule was released, it was uncertain how a franchisor could take advantage of contemporary technology to deliver disclosure documents and remain compliant with the FTC Rule. In initial drafts of the Amended Rule, the FTC had proposed that delivery of UFOCs through e-mail, through websites or through the use of CD ROMs would be authorized, provided certain paper disclosures also were made. The Amended Rule now shifts the burden to franchisors to determine how they will deliver their UFOCs, and to obtain evidence of proper disclosure in case of a dispute. Franchisors must merely "advise the prospective franchisee of the formats in which the disclosure document is made available, any prerequisites of obtaining the disclosure document in a particular format, and any conditions necessary for reviewing the disclosure document in a particular format." The UFOCs must still be in a single document, and may not contain pop up ads or links to extraneous materials. The effect of the change is to make the disclosure process much easier, faster and cheaper. This is an enormous leap ahead of Canada's domestic franchise legislation, where Prince Edward Island is the only province allowing delivery of franchise disclosure documents electronically, not just by paper, as is the case in Ontario and Alberta.

State Franchise Sales Laws Remain

Each of these changes eases the burden and cost of testing the U.S. franchising market. However, Canadian franchisors contemplating U.S. franchise expansion should recall that under the country's federal system, state laws also regulate franchise sales and relationships. States may adopt laws which increase franchisee protections. Fourteen states now have laws which require franchisors to register or file their franchises with a state agency, or to qualify for an exemption, before they may offer to the public.[1] Franchisors which do not have a U.S. trademark registration also may be subject to filing and short form disclosure requirements under state business opportunity sales laws. Franchisors with U.S. trademark registrations are generally exempt from state business opportunity laws. However, in a handful of states, franchisors must make a simple filing to claim the exemption before they may sell franchises.

How these states will react to the Amended FTC Rule, and whether they will change their own standards to track the FTC's standards remains to be seen.

Taking Advantage of the Amended Rule

For Canadian franchisors interested in testing the U.S. market, the Amended Rule eliminates much of the initial compliance cost and frustration associated with the laws which have governed franchising for the last 27 years. However, despite its obstacles, one of the benefits for Canadian franchisors of the old FTC Rule has been the need to consider issues raised by UFOC disclosures before talking with prospective franchisees. Canadian franchisors could not previously comply without knowing the fees they would charge, the types of agreements they would use, and the suppliers and products their franchisees would need to use. They had to prepare reasonable

[1] States with franchise registration or filing laws include: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

estimates of startup expenses for franchisees, and they had to disclose the status of their trademark registrations in the U.S.

Even with the changes, Canadian franchisors should apply for registration of their trademarks before coming to the country. They should analyze their costs and fee structures, and evaluate differences in operating procedures in different markets. If they only offer franchises outside the states with franchise registration laws, they will not need a UFOC and franchise agreement when they meet with a prospective franchisee. However, they should realize that once agreement deal terms have been reached, the time required to properly draft a U.S. franchise agreement to satisfy U.S. laws, to prepare a UFOC and a compliant financial statement will usually exceed one month. Disclosures must be delivered fourteen days before a letter of intent is signed. It usually takes additional time to gather information and instruct U.S. counsel before any drafting can begin.

Thus, advance planning will substantially shorten the time between the excitement of finding the right U.S. franchise partner, and the day agreements may be signed.

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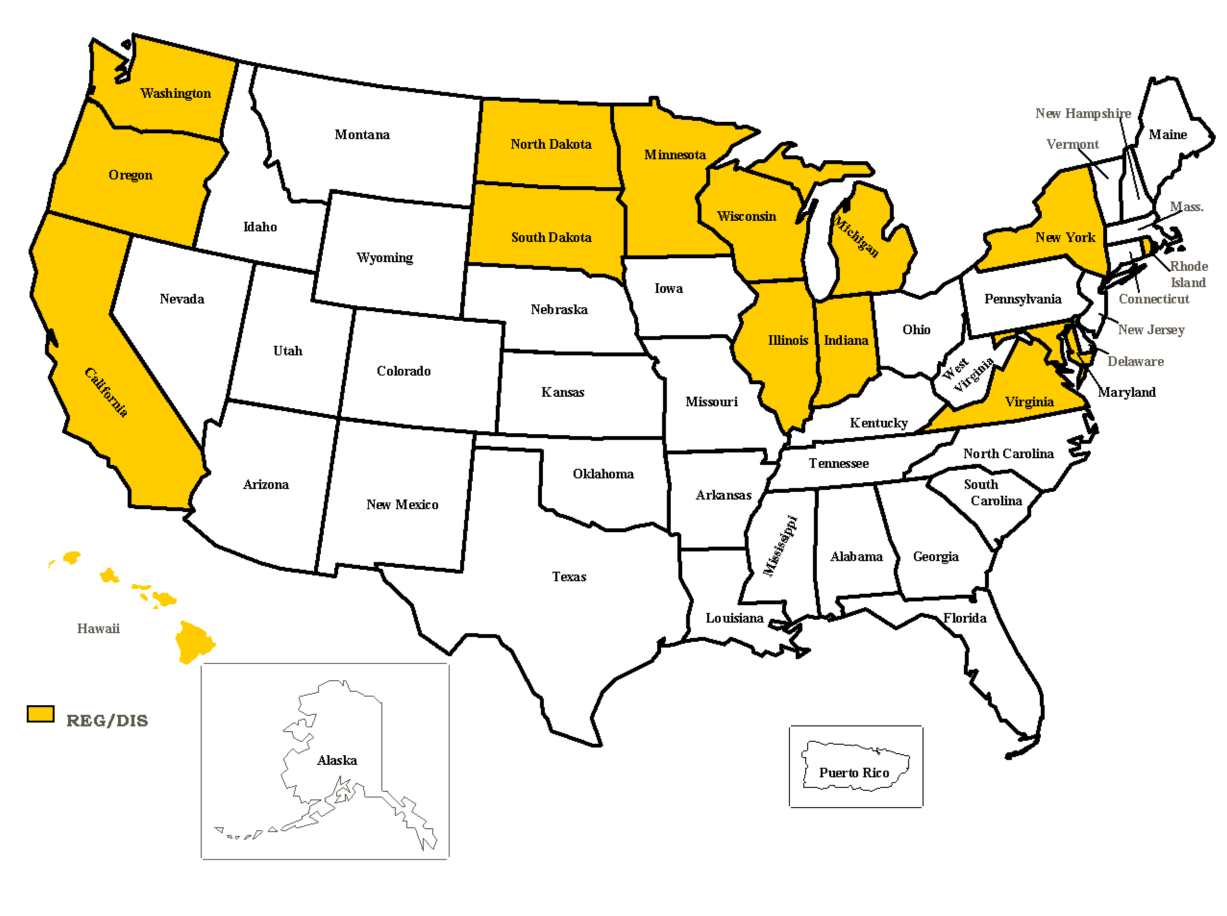
State Franchise Registration and Disclosure Laws



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