BRINGING A FOREIGN FRANCHISE SYSTEM TO THE UNITED STATES

George J. Eydt
Hodgson Russ LLP
Toronto, Ontario

and

Stuart Hershman
DLA Piper LLP (US)
Chicago, Illinois

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BRINGING A FOREIGN FRANCHISE SYSTEM TO THE UNITED STATES

I. INTRODUCTION

For most international franchisors, expansion into the United States represents both a significant opportunity and a daunting task. The size of the consumer-based economy in the United States creates the potential for income streams that cannot be achieved in most other countries. However, the level of competition in the United States can be intense, and there is regulation and taxation at both the federal and state levels that must be properly managed. This paper canvasses some of the critical issues surrounding entry by international franchisors into the U.S. market.

II. ADAPTATION TO AMERICAN CULTURE AND ECONOMIC STRUCTURE

A foreign franchise system seeking expansion into the United States, whether due to long-range strategic planning or responding to expressions of interest from a potential United States franchisee, will encounter the same practical issues that a United States-based franchise system encounters when expanding abroad. While the foreign brand might have established a strong market presence in its home country and elsewhere outside the United States, that success alone might not translate into similar success in the United States market. Legal, cultural, linguistic, perception, and stylistic issues, as well as simple matters of “taste,” are potential barriers to entry to, and undoubtedly will impact success in, the United States market. Numerous foreign franchise systems entering the United States in the past have not, for various reasons, gained traction for their concepts and have experienced limited growth or failed completely.

A prospective entrant into the United States franchise marketplace must understand the United States legal system, including the topics addressed in this paper. Equally if not more important is “business” related research. The preliminary issue is whether there is an existing market and demand in the United States for the product or service class or circumstances making it more likely than not that the entrant can create such a market and demand. If there is an existing market and demand, is the market saturated or over-populated with competitors? Is there room for a new brand? Is the new brand sufficiently different or distinct from existing participants? The foreign entrant should: (a) explore existing consumption patterns and trends; evaluate the market's potential size; (b) determine existing distribution patterns for similar products or services; (c) consider franchising’s prevalence in the sector as a method of distribution; (d) conduct market research to identify the target market and to position the product or service strategically toward that market (companies should not assume that marketing strategies successful in their home countries will be equally successful in the United States); (e) determine the cost and effectiveness of advertising media available to reach the target market; (f) determine the need to modify or supplement the primary trademarks to conform to the likely marketing strategy; (g) determine whether product modifications are needed to adapt the business to local use/custom/taste; and (h) determine whether a full or limited product line should be offered and whether store size and design modifications should be made.

Related considerations include: (a) equipment and product sourcing: Identify necessary equipment and products; determine export/import restrictions; identify potential local suppliers; make an economic and reliability comparison of importation versus local supply; and evaluate the ability to protect trade secrets with local suppliers; (b) the local labor market: How will minimum wage laws affect the business model's profitability; is the sector unionized; are appropriately skilled employees available; and is training feasible; (c) local real estate market:
What are the availability and cost of appropriate sites; are alternative distribution channels feasible; and what are build-out costs and timelines; (d) local financial resources: The ability to borrow or raise funds locally may vary dramatically, especially in the current economic climate. Will U.S. franchisees be able to fund their projects? and (e) not to be overlooked, the foreign system’s internal organizational considerations: Does the system have the financial and management resources necessary and available for the project, bearing in mind that it likely will take more money and effort to undertake the project successfully than initially contemplated?

III. TEST STORES

Whether the foreign system should or must operate its own “test” outlets in the United States before seeking to export its concept is a difficult question. Although common sense suggests that the foreign franchisor should do so for many legitimate business reasons, no law in the United States expressly requires the foreign franchisor to do so. That decision will be impacted primarily by the cultural commonality of the foreign franchisor’s home country and the United States, the nature of the products or services involved and whether there already is an established marketplace, the foreign franchisor’s financial and management resources, its impetus for entering the U.S. market (e.g., long-range planning or expressions of interest from a potential U.S. franchisee), the competitive landscape (i.e., how quickly must the foreign franchisor enter the market to establish a footprint or beat a competitor), and the foreign franchisor’s proposed form of expansion in the United States. Just as there is no “right” or “wrong” answer for the U.S.-based franchisor seeking to expand internationally—indeed, most franchisors typically do not establish their own “test” units in the target foreign country—so too there is no right or wrong answer for the foreign franchisor entering the United States.

All other factors being equal, though, the foreign franchisor can benefit greatly from operating test outlets in the United States before commencing a formal franchise program or expanding its program aggressively. The primary benefits include: (a) establishing the desirability/acceptance of the foreign franchisor’s product/service in the U.S. market and assessing what, if any, changes should be made to promote potential success; (b) establishing a prototype unit for the U.S. market and determining its cost parameters (important information for Item 7 of the foreign franchisor’s Franchise Disclosure Document); (c) assessing the types of geographic markets that the foreign franchisor should target; (d) building the supply chain; (e) confirming the concept’s (potential) profitability in the U.S. market; (f) developing initial training and ongoing franchisee support programs while “on the ground”; (g) determining the appropriate fee parameters for the anticipated franchise offering based on the foreign franchisor’s actual experience in the market portending a franchisee’s likely experience; (h) working out the “kinks” in the system; and (i) laying the groundwork for future profit if a successful test outlet can later be sold as a franchised unit at a generous multiple of cash flow.

If the foreign franchisor is prepared to operate test outlets in the United States, then where, how many, and for how long? The foreign franchisor should earmark those geographic areas most similar to the areas in its home country where the concept has achieved its greatest success or is most likely to succeed. How long the test outlet operates depends on the geographic market and the nature of the product or service. Is the product or service “seasonal,” that is, does consumption typically fluctuate depending on the time of year due to weather or holiday considerations or school schedules? If seasonal, operating the test outlet through the entire season cycle is ideal. The number of test outlets depends on the foreign franchisor’s financial and management resources and its expected target markets for early entry into the United States. If the foreign franchisor is initially focused on one core market, then one
test outlet may suffice. However, if the foreign franchisor is targeting several different geographic markets for early entry, a test outlet in each market would be ideal.

The structure of the foreign franchisor's entry into the U.S. market also is relevant. There might be situations where the foreign franchisor can develop and support franchises in the United States directly from its home country. Alternatively, the foreign franchisor might consider establishing a branch office or subsidiary company in the United States to grant the franchises. While these alternatives will be dictated by numerous legal and business considerations, they also determine the practical necessity of the foreign franchisor's first operating test outlets.

There are four main franchise growth vehicles: (1) direct unit franchising; (2) area development; (3) master franchising; and (4) development agents/area representatives. In direct unit franchising, the franchisor grants the franchisee the right to develop and operate one outlet at a specific location or within a defined area. Area development entails the franchisor's committing to grant multiple individual franchises to the same franchisee or ownership group within a defined geographic area over a specific timeframe. Each unit is governed by a separate franchise agreement, and the "area developer" must develop and operate the units on its own; no subfranchising (described below) is involved. Subfranchising, or master franchising, which historically has been the favored growth vehicle for U.S.-based franchisors expanding abroad but increasingly is being replaced by area development, is a three-tiered structure. The master franchisor grants "subfranchisers" or "master franchisees" the right to franchise third parties, or "subfranchisees," to operate units. Subfranchisors sign subfranchise agreements directly with subfranchisees. The master franchisor typically is not a party to those agreements. The subfranchisor effectively becomes the franchisor in the particular market, assuming the master franchisor's traditional role. Development agents or area representatives are a middle ground between subfranchising and traditional area development. The franchisor grants the development agent/area representative the right to develop and operate its own outlets, and recruit prospective franchisees to develop and operate outlets, in a designated market. The development agent/area representative typically must develop and operate its own pilot or flagship unit before commencing franchisee solicitation activity. In return for a substantial share of the initial franchise fee and ongoing royalties, the development agent/area representative must advertise for prospective franchisees and, once the franchisor has granted the franchises directly, help the franchisees secure sites and build out their units, help provide training, support the franchisees during their franchise terms, and help the franchisor enforce system standards.

Operating test outlets in the United States before commencing the franchise program appears to serve a greater purpose when the foreign franchisor's expected growth strategy is direct unit franchising or development rights, where no single franchisee is likely to take that first investment step unless the concept has some operational credibility in the United States. Conversely, the subfranchising or development agent/area representative strategy entails a greater financial and operational commitment by the subfranchisor or development agent/area representative, who agrees to spearhead market development and therefore might be expected to operate the first "test" outlets.

Some foreign franchisors will consider developing test units through joint ventures with third parties (typically their expected first franchisees) or "licenses." The key is to ensure that the test relationship does not itself constitute a franchise, if the foreign franchisor has not yet complied with applicable franchise registration and disclosure regulations in the United States.
IV. INTELLECTUAL PROPERTY PROTECTION

A. Trademarks

It is widely recognized that a trademark is the cornerstone of any franchise program. Absent a strong, identifiable, and protectable trademark, a franchise system will have difficulty distinguishing itself as a brand amidst thousands of other franchise systems and independent competitors. Consequently, the foreign brand seeking to enter the U.S. market is well-advised to take the steps necessary at the earliest possible opportunity to protect its core trademarks.

Trademark rights ultimately are obtained through actual use of a trademark in commerce. Trademark protection can be obtained for both goods and services. The rights developed from actual use of a trademark are referred to as "common law" rights and generally are enforceable in the geographic trading area where a company first uses the trademark. Trademark rights protect against another's use of a similar mark on related goods or services if there would be a likelihood that the public would be confused about their origin.

While each state in the United States provides for trademark registrations, these typically are worthwhile only if a product or service is going to be sold in one or a few states. State trademark registrations do not provide much protection beyond the "common law" rights acquired simply from using a trademark. State trademark applications also cannot be filed until there has been actual use of a trademark in the state. Foreign franchise systems entering the United States rarely bother with state trademark registrations because their objective is to expand regionally or nationally.

Common law rights in a trademark can be expanded, and their protection substantially enhanced, through federal registration with the United States Patent and Trademark Office (USPTO) under the federal Lanham Act.\(^{1}\) While a trademark application may be filed on an "intent to use" rather than "actual use" basis, that is, based on the registrant's planned future use of the trademark rather than its past actual or current use, formal registration will not issue until the registrant shows that it has in fact used the trademark in interstate commerce in connection with the goods or services covered by the application.

There is an important exception to the requirements of U.S. use and specimens as a result of an international convention to which the United States is a party.\(^{2}\) If an application filed in the United States is based on an application that was filed in another member country no more than six months earlier, there is no need to allege or prove use of the trademark in the United States or provide specimens, and the U.S. application will be treated as if it were filed on the date of filing in the "home" country. Similarly, the use requirements can be avoided by filing an application in the United States based on a trademark registration in another country; in that case, though, the date of the U.S. application is the date it was actually filed rather than the date of filing of the "home" country registration. In both instances, foreign applicants can obtain U.S. trademark registrations without ever proving use of the trademark in the United States, extremely advantageous because it is not possible for a domestic applicant to obtain a U.S. trademark registration without proving use and providing specimens. However, all registrants

\(^{1}\) 15. U.S.C. §§ 1051 et seq.

are subject to the laws of abandonment—where a registration may be subject to cancellation if the trademark has not been used for three consecutive years—and all registrants must provide evidence of use between the fifth and sixth anniversaries after registration in order to maintain trademark registrations. A trademark registration is effective for ten years and renewable for additional ten-year periods if the trademark remains in use.

B. Patents

A patent is a right granted by a government to exclude others from making, using, importing, selling, or offering for sale a certain defined invention. The United States grants patents under the United States Constitution “To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.” In exchange for disclosing to the world how to make and use an invention, the inventor obtains a monopoly on the invention for the patent’s term. A single patent can give its owner powerful competitive advantages. Patents can be used to bar later-coming, more economically powerful competitors from lucrative markets, to protect price premiums of products over generic products without patented technological advances, or to generate substantial income through licensing. A company holding a patent can completely control use of the patented technology during the patent term.

The United States Patent Act permits the patenting of any “new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof.” The range of inventions covered is quite broad. The term “process” refers to any procedure leading to a useful result and, of particular interest in franchising, may even include business methodology.

The most common type of patent the USPTO issues is the “utility patent,” covering a functionally novel and non-obvious invention. There also are “design patents,” protecting the ornamental appearance of novel designs, and “plant patents,” governing rights in asexually reproduced living plants. A utility patent gives the patent holder the right to exclude others from making, using, selling, offering for sale, or importing the patented invention for a statutorily determined time period. Utility patents usually expire twenty years from the filing date. Design patents last fourteen years from the issue date.

In the United States, and unlike most foreign countries, the person entitled to a patent is the first to invent rather than the first to file a patent application. This makes recordkeeping critical. During the inventive process in which an inventor’s concept is transformed from an abstract idea into a working product, it is important to keep detailed, dated records of all work developing the invention. The inventor must be diligent from conception to reducing the invention to practice. Reduction to practice can be actual, in which a working model is actually produced, or “constructive,” meaning that a patent application has been filed.

Even though a patent usually lasts for twenty years from the application date, the USPTO requires maintenance fees every four years to keep the patent in force. The patent expires if these fees are not paid. Once a patent application is filed with the USPTO, the

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3 U.S. Const. Art. I.
4 35 U.S.C. §§ 1 et seq.
applicant may mark products covered by the claims with the words “patent pending” or “patent applied for.” This indicates that an application has been filed and neither abandoned nor issued. Because a U.S. patent application is kept secret while being reviewed, a “patent pending” notice might deter competitors unable to determine the extent of possible patent protection in the invention or when a patent will be granted.

When a patent issues, patented articles should be marked with the designation “patent” or “pat.” and the patent number. This marking puts the public on notice that the article is protected. A patent owner selling articles without such a notice cannot recover for acts occurring before an alleged infringer receives actual notice of the patent and the patent owner’s rights.

C. **Copyrights**

Copyrights are also provided by the United States Constitution.® Copyright protects any “work of authorship” fixed in a “tangible medium of expression,” including literary, musical, and dramatic works; choreography; pictorial, graphic, and sculptural works; and audiovisual and architectural works. However, copyright does not protect ideas or concepts, facts or discoveries, or procedures and processes, regardless of the form in which they are described or explained. The creator of the particular work owns the work unless it is assigned in writing or is a “work for hire.” The copyright in the work of employees created during their employment is owned by their employer. Copyright in works commissioned from independent contractors can belong to the commissioning party by agreement before the work is created. The copyright owner has exclusive rights in the work, including the rights to reproduce the work and prepare derivative works, to distribute the work publicly by sale, rental, or lease, and to perform or display the work publicly. Copyright has relevance in franchising to protect, among other things, operations and other manuals, blueprints for store design, menu boards, sales and advertising materials, and website pages.

Copyright arises when a work is created in fixed form. Registering copyrights with the U.S. Copyright Office is necessary only when suing for infringement. When timely, registration gives the owner the right to recover statutory fees and damages. Copyrights last for the life of the author plus seventy years. While copyright notices like “©” no longer are required, they are recommended because they have a deterrent effect, they correct an inaccurate assumption that some work is not protected, and they parry an infringer’s attempt to claim innocent infringement. Proper copyright notice includes the symbol © or the term “Copyright,” the year of the work’s first publication, the copyright owner’s name, and (optional) “All rights reserved.” Certain use of copyright work without permission is excused if it involves “fair use.”

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® Id.
V. TAX CONSIDERATIONS

A. U.S. Taxation

Before undertaking tax planning, it is important for foreign franchisors to understand some basics of U.S. taxation.

1. Income Tax

   a. Federal and State Income Tax Rates

   The U.S. federal government taxes corporate income at an average rate of 35%. State governments also tax corporate income at rates ranging from 0-12% with the average rate being 6.6% and state income taxes being deductible from federal income taxes. Taking into account the deductibility of state income taxes, the average combined federal and state tax rate currently is 39.3%. In 2008, the United States had the second highest average corporate income tax rate among member countries of the Organization for Economic Co-operation and Development. The tax rates actually paid by U.S. corporations might be lower due to various incentives, credits, exemptions, and loopholes not uniformly applied to all corporations.

   Income derived from a U.S. limited partnership or limited liability company ("LLC") may subject individual foreign franchise owners to taxation at U.S. personal income tax rates. The federal government taxes personal income at marginal rates of up to 35%. State individual income tax rates range from 0% to a highest marginal rate of 11%. State individual income tax also is deductible for federal tax purposes.

   b. Federal Taxation of Foreign Entities

   The U.S. federal income tax rules applicable to foreign corporations selling into the United States depend on whether the foreign corporation has the benefit of a tax treaty. The primary areas of difference are: (1) the rules applying to determine whether the corporation’s business profits will be subject to U.S. federal tax, and (2) the rate of branch profits tax that will apply to U.S.-taxable profits.

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6 Some U.S. cities also tax corporate and individual income, e.g., New York City.
7 I.R.C. § 11 specifies the schedule of corporate rates. I.R.C. §§ 55, 56 specify an alternative minimum tax. All references to "I.R.C." or to "Code" are to the Internal Revenue Code of 1986, as amended.
8 States with 0% corporate income tax often have other methods of collecting revenues, such as Washington’s gross receipts tax, which may be a burden on start-up businesses (Wash. Rev. Code § 82.04.220).
10 Randy Myers, Taxed to the Max, CFO Magazine, March 1, 2009.
12 Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming have no personal income tax. Hawaii has the highest marginal rate at 11% for income over $200,000 (U.S.).
Regarding the first difference, a treaty corporation's business profits are subject to U.S. federal tax only if the corporation maintains a "permanent establishment" in the United States as defined in the applicable treaty. In contrast, a non-treaty corporation is subject to U.S. federal tax on any business income that is "effectively connected with a U.S. trade or business" as defined in the Code, whether or not the corporation maintains a "permanent establishment" in the United States.

Regarding the second difference, a non-treaty corporation's U.S. profits are subject to a branch profits tax at the rate of 30%, whereas a treaty corporation's U.S. profits are subject to a reduced rate as specified in the applicable treaty. Because non-treaty corporations are subject to a 30% branch profits tax rate, a treaty corporation generally does not want to allocate profit to a non-treaty corporation unless the profit is completely exempt from U.S. federal tax, i.e., the non-treaty corporation is not considered to be "engaged in a U.S. trade or business." However, if the non-treaty corporation will not be "engaged in a U.S. trade or business" and can perform substantial services outside the United States, it can be advantageous to allocate profit to the corporation which will completely avoid U.S. tax and defer tax in the home country.

A non-treaty corporation is subject to U.S. federal tax on the income which is "effectively connected with a U.S. trade or business." This phrase serves two important, but different, functions. First, it distinguishes business income from non-business (passive) income. Second, it limits U.S. taxation to income which is deemed to have a "U.S.-source" and excludes from U.S. tax income which has a "foreign-source."

The rules for determining the source of income depend primarily on the income's character. Income from services generally is sourced where the services are performed. Income from services performed within the United States is U.S.-source, and income from services performed outside the United States is foreign-source. In contrast, subject to the exception noted below, income from the sale of inventory generally is sourced where title passes. If title passes within the United States, the income is U.S.-source; if title passes outside the United States, the income is foreign-source. Title is deemed to pass where the seller transfers all substantial right, title, and interest in the property to the buyer. An exception exists for sales attributable to an office or fixed place of business within the United States. Income from those sales generally is considered U.S.-source income even if title passes outside the United States.

Three elements must be present for income to be "attributable" to a U.S. office or fixed place of business: (1) the U.S. office must be a "material factor" in producing the income; (2) the U.S. office must regularly carry on activities of the type from which the income is derived; and (3) the income attributable to the office must be "properly allocable" to that office. A U.S. office will be a material factor if the office, through its personnel in the ordinary course of performing their business duties, actively participates in soliciting orders, negotiating sale

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19 Under the Convention between The United States of America and Canada with respect to Taxes on Income and on Capital, Sept 26, 1980, as amended, U.S.—Can. (the "Canada/U.S. Tax Treaty"), "permanent establishment" includes an office, factory, branch, place of management, or other fixed place of business in the United States, and the use of employees (or other dependent agents) within the United States who regularly exercise authority to conclude contracts on behalf of the Canadian corporation (art. V, para. 2 and 5). It does not include mere advertising activities, the storage of goods in a U.S. warehouse, acting through an independent agent, or the use of employees who do not regularly exercise authority to conclude contracts (art. V, para. 6 and 7).
contracts, or performing other significant services not covered in a separate agreement with the buyer that are necessary to consummate the sale. If the U.S. office is not a material factor, the sales income will not be considered effectively connected with a U.S. trade or business; provided, a foreign office materially participates in the sale.

c. State Taxation of Foreign Entities

i. Nexus

A U.S. state's ability to impose tax obligations on an out-of-state corporation—whether those obligations are for corporate, sales, franchise, or other taxes—is limited by the U.S. Constitution and potentially by federal and state laws. The nature and frequency of contacts that an out-of-state corporation must establish in a state before it may be subject to that state's taxing jurisdiction generally is referred to as "nexus."

Nexus issues come up in both the sales tax and income tax contexts; the rules generally are similar. With respect to sales tax, the U.S. Supreme Court's decision in Quill set the bright-line test in reaffirming that the commerce clause of the U.S. Constitution prohibits a state from imposing sales or use tax compliance responsibilities on an out-of-state corporation if that corporation has no "physical presence" within the taxing state. Other Supreme Court cases indicate that the type of physical presence necessary to create sales tax nexus may be as slight as a temporary presence of the corporation's property or personnel in the state and that any contact with the taxing state beyond the mails or common carrier may give rise to sufficient nexus. States have taken their cue from the Supreme Court and been equally aggressive asserting the existence of nexus. Some states have taken the position that, while physical presence is required, it need not be more than the "slightest presence."

The nexus rules applicable to state corporate income taxes are similar, although they are not entirely clear because the U.S. Supreme Court has not specifically ruled in this area. Especially important to franchisors, some states have found that a corporation's mere purposeful exploitation of a state's market for services and the presence of intangible property in

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14 U.S. Const., art. I, § 8, cl. 3.
16 In Felt and Tarrant Co. v. Gallagher, 306 U.S. 62 (1939), two soliciting sales agents and a rental office in the state created sufficient nexus. In Standard Steel Co. v. Washington Revenue Dept., 419 U.S. 560 (1975), one resident employee operating out of his home in the taxing state created sufficient physical presence. In National Geographic, 430 U.S. 551 (1977), two business offices unrelated to the taxpayer's sales activities within the state created sufficient physical presence.
18 The Supreme Court recently declined to review state income tax nexus issues in Capital One Bank v. Commissioner of Revenue, 899 N.E. 2d 76 (2009), cert. denied, S.Ct. 77 USLW 3690 (U.S. Mass, June 22, 2009) (No. 08-1169) and Geoffrey, Inc. v Commission of Revenue, 899 N.E. 2d. 87 (2009), cert. denied, S. Ct. 77 USLW 3690 (U.S. Mass, June 22, 2009) (No. 08-1207).
a state satisfy the U.S. Constitution’s limitations on a state’s jurisdiction to impose income taxes. The now infamous Geoffrey case provides an example.19

Under the Commerce Clause of the United States Constitution, a corporate taxpayer has the right to insist on the division of its tax base if it can demonstrate that it is taxable in another state. In other words, the taxpayer can demand that the state attribute a portion of its income to the other state wishing to impose an income tax, thus avoiding double taxation.

ii. No Applicable Treaties

Foreign franchisors may mistakenly assume that their protection from federal-based taxes under a treaty with the United States also protects them from state-based taxes. No state, however, has a tax treaty with a foreign country. That said, special rules may apply in some states exempting a federally-exempt company from state taxes. For example, companies with no federal taxable income due to a treaty may escape tax liability in states using federal taxable income as the starting point for their taxation.

2. Tax on the Sale of the U.S. Franchise Business

A sale of the U.S. franchise business may result in U.S. taxation depending on the form of the U.S. operating entity and the nature of the sale. Generally, gain from selling stock of a foreign corporation (with a U.S. branch) is exempt from U.S. tax. If the foreign corporation sells the assets of its U.S. branch, however, gain from the sale may be subject to U.S. tax.20 Repatriation of the sale proceeds generally is exempt from branch profits tax. If a foreign shareholder sells stock of a U.S. corporation, gain from the sale is generally exempt from U.S. tax21 unless the corporation is or has been a “U.S. real property holding corporation” (“USRPHC”) during any of the previous five years.22 If a U.S. corporation sells its assets and liquidates, gain from the sale is subject to U.S. tax (in the hands of the U.S. corporation),23 but the liquidating distribution generally is exempt from U.S. withholding tax as capital gain.24 Gain from the sale of a U.S. partnership or LLC interest is taxable in the United States to the extent the gain is allocable to U.S. situs property of the partnership or LLC.25 Sale of appreciated assets prior to a liquidation or sale of a partnership or LLC interest will result in taxable gain to the partners or LLC members.

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20 E.g., art. XIII, para. 2 of the Canada/U.S. Tax Treaty.

21 Gain is taxed only if it is subject to The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), I.R.C. § 1445, and § 6039C, or effectively connected with a U.S. trade or business, I.R.C. § 871(a)(2).

22 I.R.C. § 897(c)(2).

23 I.R.C. §§ 336, 331, 332.


25 The IRS position is that the disposition of a partnership interest is subject to U.S. tax to the extent the assets are effectively connected to a U.S. trade or business; see Rev. Rul. 91-31, 1991-1 C.B. 979.
3. **Estate Tax**

A foreign citizen who is not resident in the United States (a Non-Resident Alien) is subject to the U.S. estate tax regime if he or she owns U.S. situs property upon death. Subject to exemption, U.S. estate tax is payable upon the property’s full value at rates of up to 45% in 2009. U.S. situs property includes equity interests in a business entity formed under U.S. law. A Non-Resident Alien is allowed a “unified credit” exempting the first $60,000 of U.S. situs property from estate tax. U.S. tax treaties may provide for greater relief.

Tax treaty credits may alleviate most or all of the U.S. estate tax exposure at the franchise owner’s death, and no further planning is necessary. If not, other planning possibilities exist, including using a blocker corporation, a properly structured family trust, or life insurance.

B. **Identify Past Non-Compliance**

Foreign franchisors might have a prior history of doing business in the United States that pre-dates their relationship with current legal counsel. Perhaps they sold products directly to U.S. distributors or retailers, previously tried master franchising, or already have set up a test store in the United States. It is important that current legal counsel review this prior history for any federal, state, and local tax compliance issues.

If tax compliance issues are identified, the foreign franchisor may participate in “voluntary disclosure” programs. Some programs allow taxpayers to enter into compliance without fear of civil or criminal penalties or excessive look-back periods. For example, New York will allow taxpayers to pay three years’ worth of income taxes plus interest only and will limit any audits or investigations to this three-year period. Companies also may work with the Multistate Tax Commission, which has a program designed to assist taxpayers with voluntary disclosures in several states. States participating in the Streamlined Sales Tax Project offer sales tax amnesty to taxpayers willing to participate in the project on a going-forward basis.

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26 It is likely that partnership interests held directly by foreign individuals are part of the non-U.S. person’s U.S. estate to the extent the partnership holds U.S. situs assets (see Rev. Rul. 55-701, 1955-2 C.B. 836). However, there is no definitive authority directly on point.

27 *E.g.*, under the Canada/U.S. Tax Treaty, a Canadian NRA’s estate would qualify for a potentially greater U.S. unified credit exemption amount, based on the percentage of U.S. situs asset value over worldwide asset value multiplied by the unified credit exemption amount allowable to a U.S. citizen which is $3.5M for 2009.

28 NYS TSB-M-09(6), *Voluntary Disclosure And Compliance Program Legislative Change Regarding The Disclosure Of Information* (May 2009) (containing information on New York State’s new voluntary disclosure program).


C. Tax Planning

1. Choice of Business Entity/Structure

Foreign franchisors have numerous alternatives for their U.S. operating entity, including: (1) a branch or division of the existing foreign business entity; (2) a U.S. corporation; (3) a U.S. partnership; (4) a U.S. limited liability company; (5) an entity formed in a low-tax jurisdiction; or (6) a "hybrid" entity that is taxed as a corporation in one country and as a flow-through entity in the other. Some of these choices also may require the use of intermediary entities in the United States, the franchisor's home country, or a low-tax jurisdiction. To add to the complexity, the franchisor also may choose to divide its revenue into different streams, dictating the use of additional entities.

2. Tax Planning Factors

It is important to make the right choice of U.S. operating entity and related tax structure at the outset because a change may create both practical and tax problems. While it is not possible to canvas all of the structuring options described above within the scope of this paper, making the right choice depends on a number of factors that are more easily discussed, including the nature of the franchise business, whether any owners intend to relocate to the United States, whether there are U.S. investors, the potential for significant start-up losses, whether profits will be repatriated to the franchisor's home country each year or reinvested in U.S. operations, the terms of any tax treaty between the United States and the franchisor's home country, and the owners' exit strategy. The following is a brief examination of these factors in the franchising context.

a. Nature of the Franchise Business

In a "Package Franchise", the franchisee adopts the franchisor's trademarks and method of business operation (e.g., a tax preparation franchise). In a "Product Franchise", the franchisee distributes products bearing the franchisor's mark that were produced either by the franchisor or under its control (e.g., an ice cream store franchise). If a foreign franchise company intends to supply products directly to franchisees, such as in a Product Franchise, it has a built-in mechanism for the repatriation of profits. The foreign franchisor's profits on direct sales to U.S. franchisees generally would not be subject to tax in the United States, if the foreign franchisor has the benefit of a tax treaty and does not maintain a permanent establishment, or, if there is no tax treaty, title passes outside the United States and is not attributable to an office or fixed place of business within the United States. Even if the foreign franchisor sells products to its own U.S. subsidiary for resale to franchisees, the foreign franchise company's profit from the related-party sale would not be subject to income tax, although the IRS would expect the U.S. subsidiary to make a reasonable margin on resale that would be subject to U.S. tax.

32 Id.
33 See subsection d. below for a more complete discussion of profit repatriation strategies.
b. **Residency of the Franchise Owners**

Occasionally, an owner of a foreign franchisor uses U.S. expansion to facilitate his or her relocation to the United States. To the extent the owner plans to remain in the U.S. permanently, tax planning should take this factor into account. Using a flow-through entity, such as a limited partnership or LLC, may help eliminate a layer of tax for the U.S. resident. Similarly, if the expansion to the United States requires an injection of capital from U.S. investors, using a flow-through entity may be considered for the benefit of the U.S. investors.

The limited liability company has become a popular choice of business entity for private business owners in the United States. For U.S. purposes, LLCs offer the dual benefits of liability protection and flow-through tax treatment. Although U.S. "S corporations" also offer these dual benefits, LLCs generally are more flexible and accessible than S corporations because foreign individuals and corporations cannot own shares in an S corporation but can own equity interests in an LLC. Unfortunately, tax treaties have not necessarily kept up with this relatively new form of business entity, and direct ownership by foreign persons of equity interests in an LLC may be problematic. If not all of the franchisor owners will reside in the United States, it may be necessary for the foreign owners to use a U.S. corporation as a "blocker" to insulate them from any negative tax effects. Although using a blocker may solve the worst negative tax effects, it is not necessarily tax efficient for the foreign owners.

The limited partnership is another business entity that offers liability protection and flow-through tax treatment. A limited partnership is slightly more cumbersome than an LLC because of the need to form a business entity to act as general partner, but generally there is less likelihood of problematic tax treatment for foreign owners. However, a foreign partner should ensure that profits of a U.S. limited partnership are taxed by the partner’s home country in a way that allows for use of foreign tax credits.

c. **Significant Start-Up Losses**

Franchisors expanding into the United States may experience significant losses in the first few years because of the expenses associated with tax planning and structuring, franchise law compliance, audited financial statements, and creating U.S. operations in advance of selling any franchises. Significant losses may quickly change to significant gains by virtue of exponential growth in the number of franchised units and each unit’s increased success as the brand gains recognition in the U.S. market. If U.S. operations are expected to generate significant start-up losses, the franchise owners may want to flow these losses back to the home country to offset profits. Using a branch or division of the foreign franchisor may be considered. In many foreign jurisdictions, losses incurred directly by a foreign branch or division are fully deductible. Once U.S. operations become profitable, it may be possible to put another structure

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34 All 50 states and the District of Columbia have adopted LLC statutes.
35 The name comes from Subchapter S of the Code, I.R.C. §§ 1361-1379.
36 I.R.C. § 1361(b)(1).
37 *E.g.*, Canada, which does not have an LLC equivalent, generally taxes an LLC as a corporation rather than as a partnership. Direct ownership of LLC interests may be problematic for Canadians.
in place. The tax consequences of converting to a new structure should be examined at the outset.

State taxation of a branch differs from the state taxation of a U.S. corporation. A U.S. corporation's taxable profits generally include only the profits of the U.S. corporation itself and do not include profits of affiliated foreign corporations. In contrast, taxable profits of a U.S. branch of a foreign corporation generally include the entire worldwide income of the foreign corporation as apportioned to the state. This may mean that state income tax is payable even though U.S. operations are not profitable simply because worldwide operations are profitable. At the federal level, the foreign corporation operating a U.S. branch must also report worldwide income but tax treaties may eliminate taxation of non-profitable U.S. operations. Avoiding reporting of worldwide financial information to the IRS and state taxing authorities and possible state taxation of profit derived from worldwide operations may cause foreign franchisors to avoid using a branch or division.

d. Reinvestment Versus Repatriation of Profits

i. Reinvestment

International tax planning must take into consideration whether profits will be repatriated to the home country or reinvested in U.S. operations. For Product Franchise systems, there may be significant opportunities to invest in the United States (e.g., building a warehouse facility or manufacturing operation).

ii. Repatriation of Funds

However, if profits from U.S. operations are to be repatriated to the foreign franchisor's home country, there are various mechanisms that may be used. The goal in most tax planning exercises is to maximize the use of mechanisms that are the most tax efficient. The mechanism's effectiveness will be dictated in part by the structure of the business and the terms of any applicable tax treaty. The U.S. withholding tax rate on payments, such as interest, dividends, rents and royalties, made by U.S. business entities to foreign affiliates is generally 30%. Tax treaties may reduce the withholding tax rates to as low as zero. The following discusses some of the more common repatriation mechanisms used by foreign franchisors. If the franchisor's profits will significantly exceed available tax efficient repatriation mechanisms, a more complex tax structure may be required.

38 This may be true even in states such as California that use the "unitary method" of taxation, because profits of foreign affiliates may be excluded by making a "water's edge" election. CAL. REV. & TAX. CODE § 25110.

39 The apportionment formula generally measures the portion of the corporation's overall sales, property and payroll that are located within the state. Many states "double-weight" the sales factor, thus increasing the formula to a four-factor test. New York and certain other states have recently moved to a sales only apportionment.

(a) Licensing of Intangible Rights

The foreign franchisor often will own all intellectual property rights and license their use to its U.S. affiliate. The foreign franchisor may charge its affiliate a reasonable royalty for using these rights. As mentioned above, one must look to the applicable treaty to determine the rate of withholding tax on the royalty payment. 41

(b) Management Services Agreements

Management fees paid by a U.S. corporation to a foreign recipient may be deductible for U.S. tax purposes. The IRS position is that management fees are generally deductible only to the extent of the cost of the services to the company providing them (where the parties are related and the company providing the services is not in the business of providing such services to third parties). 42

(c) Supply Agreements

As discussed above, Product Franchisors have a built-in mechanism to repatriate U.S. profits by charging a reasonable amount for inventory.

(d) Transfer Pricing Agreements Generally

Transfer pricing is the price at which goods, services, or intangibles are transferred across international borders by related parties. License agreements for intangible rights, management services agreements and supply agreements between affiliates are all examples of transfer pricing arrangements. Issues arise around transfer pricing because the exporting country’s taxing authority wants to ensure that not less than fair market value is paid, while the importing country’s taxing authority wants to ensure that not more than fair market value is paid. In other words, each country is worried that its tax base is being reduced for another’s benefit by the price being charged by related companies for intangibles, products, and services.

The United States added transfer pricing documentation requirements to the Internal Revenue Code in 1986. 43 These mandate the production of contemporaneous documentation setting out a reasonable basis for transfer pricing within a specific time period after they are requested. Failure to produce the documentation or producing inadequate documentation can lead to penalties of between 20-40% of the underpayment of tax of any transfer pricing adjustment resulting from audit. 44 The key components of contemporaneous documentation are an analysis of the functions, assets, and risks associated with manufacturing, providing, or creating the good, service, or intangible (“functional analysis”) and an economic analysis setting out industry comparables. The best practice is to establish contemporaneous documentation at

41 E.g. generally, payments of royalties by a U.S. corporation to a Canadian resident are exempt from withholding under the Treaty, and deductible by the U.S. corporation.

42 Treas. Reg. § 1.482-2(b)(3).

43 I.R.C. §482.

44 I.R.C. §§ 6662(e), 6662(h).
the outset of U.S. expansion and ensure that the transfer pricing parameters established in this
documentation are followed.  

(e) Intercompany Loans

The primary tax goal when capitalizing a U.S. subsidiary is to create an effective means
for repatriating profits to the foreign country while maximizing deductions in the United States.
Equity in a U.S. corporation cannot be repatriated to foreign shareholders tax-free to the extent
there are earnings and profits in the U.S. corporation. In contrast, loan principal typically can be
repatriated free of U.S. withholding tax (assuming full basis in the loan). Dividends paid by a
U.S. corporation are not deductible for income tax purposes and are subject to U.S. withholding
tax. In contrast, interest payments on a loan are fully deductible, subject to “thin capitalization”
and “interest stripping” rules and other restrictions on the deductibility of interest, and may be
subject to lower U.S. withholding rates. Therefore, capitalization with debt generally is
preferable to capitalization with equity.

(1) Thin Capitalization Rule

If the IRS determines that the U.S. subsidiaries’ debt-to-equity ratio is too high, adverse
tax results will occur. First, because the “interest” payments will be treated as a return of
equity rather than interest, the payments will not be deductible. Second, repayments of
principal, that otherwise would not be subject to tax, become subject to withholding tax, to the
extent the corporation has “earnings and profits” as determined under U.S. tax rules. Note that
the entire amount of the debt is re-characterized as equity, not simply the amount in excess of a
reasonable ratio.

(2) Interest Stripping Rule

The interest-stripping rules, designed to deal with what the U.S. Congress termed “tax
base erosion,” may disallow some part of interest paid by a corporation to a foreign related

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45 For more information on transfer pricing, see Transfer Pricing Guidelines for Multinational Enterprise and Tax
Administrations, Organization of Economic Co-operation and Development, 1995 (the “OECD Guidelines”),
which forms the basis for the transfer pricing requirements of many industrialized nations.

46 E.g., under the Canada/U.S. Tax Treaty, a 5% dividend withholding tax rate applies if a Canadian parent
corporation owns at least 10% of the voting stock of a U.S. subsidiary; a 15% rate applies in all other cases (Art.
X, ¶ 2).

47 E.g., the withholding rate on interest payments between affiliates falls to zero in 2010 under the Canada/U.S. Tax
Treaty.

48 There is no bright-line test for determining the proper debt to equity ratio, but most tax advisors view 3:1 as safe.
This viewpoint stems from a mention of this ratio in regulations proposed by the IRS in 1980 and withdrawn in
instruments, with arm’s-length commercial terms, must be signed and interest timely paid.

49 The exception to taxation as dividends, subject to withholding, occurs when the corporation does not have
sufficient earnings and profits from which to pay dividends. In that case, the payments are first treated as return
of basis and then as capital gain, neither of which is subject to U.S. tax for foreign shareholders. I.R.C. § 301.
party. A “related party” is one that owns more than 50% of the U.S. business. A guarantee of debt by a related party also may be treated as a related party interest. The rules generally restrict the deductibility of interest, if interest exceeds 50% of earnings (as determined by reference to a special formula). Any amounts of interest denied are carried over indefinitely and deducted in subsequent years when the business has “excess limitation.” As a result, calculating expected profits is essential to determine the time value of interest deductions.

(3) **Security**

If debt is significant, the foreign franchisor will want to take security over the assets of its U.S. subsidiary so that it stands ahead of general creditors, if the U.S. expansion fails. This can be accomplished by entering into a simple general security agreement when the loan is made and timely filing a lien registration statement, typically in the U.S. subsidiary’s state of incorporation or formation, all in accordance with Article 9 of the Uniform Commercial Code. The foreign franchisor will obtain priority over a related party’s assets in a bankruptcy scenario only if the lien registration statement was filed at least one year earlier.

(f) **Dividends/Distributions**

Absent a tax treaty, dividends and distribution are subject to a 30% U.S. withholding tax rate. Countries having a tax treaty with the United States may be subject to lower withholding tax rates. Because dividends are not deductible by the U.S. corporation, they generally are not an efficient mechanism for repatriation of profit.

3. **Alternative Depending on Available Repatriation Mechanisms**

If the foreign franchisor has tax efficient repatriation mechanisms, then a U.S. corporation is generally the simplest and most economical structure to form and maintain. It is a tax-effective vehicle for repatriating lower levels of income each year (up to $75,000). It provides shareholder liability protection and allows the foreign parent company to avoid having to file U.S. tax returns (including state returns where worldwide income might be taxed, as noted previously). For individual foreign franchise owners intending to remain foreign residents, it is generally desirable to hold the shares of a U.S. corporation through a foreign entity to gain protection from the U.S. estate tax, possibly reduce the U.S. dividend withholding tax rate, and possibly provide an avenue for repatriating profits free of foreign tax (as dividends from “exempt surplus”). However, if corporate profits cannot be efficiently repatriated, the net tax rate on income generated by a U.S. corporation that is ultimately distributed to foreign individuals may be higher than if another type of structure is used.

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50 I.R.C. §§ 267(b) and 707(b)(1) are referenced in I.R.C. § 163(j)(4)(A); Prop. Reg. §1.163(j)-2(g).

51 I.R.C. § 163(j)(3)(B), (6)(D) (added in 1993). Deduction of interest payments might be limited for state tax purposes as well. For example, in New York, where taxable income for state purposes is determined by “piggybacking” onto federal taxable income, the denial of interest deductions at the federal level would lead to a similar denial at the state level.

52 *E.g.*, for Canadian franchise system owners the cumulative tax rate may be in the range of 55-65%.
One alternative is using a flow through entity, such as U.S. limited partnership.\textsuperscript{53} For U.S. and most foreign tax purposes, limited partnerships are not taxable entities.\textsuperscript{54} Partnership profits are taxable to the partners. Consequently, income of partnerships with corporate partners is taxed essentially the same as (1) income of U.S. corporations, with respect to profits allocable to U.S. corporate partners, and (2) income of U.S. branches, with respect to profits allocable to foreign corporate partners. There also are special withholding tax rules that apply to partnership income allocable to foreign partners.

Profits allocable to foreign individual partners are taxed in the United States at the U.S. individual rates. In tax treaty countries, the foreign individual partner typically receives a foreign tax credit for U.S. taxes paid. A partnership’s primary tax advantage is the ability to achieve a single level of total cross-border tax on U.S. profits fully distributed to an individual foreign owner. One disadvantage of using a U.S. limited partnership is that the partnership must withhold and pay U.S. federal tax quarterly to the IRS with respect to its business income (“effectively connected income” or “ECI”) allocable (whether distributed or not) to its foreign partners.\textsuperscript{55} The amount required to be withheld is equal to the amount of ECI allocable to its foreign partners multiplied by the highest marginal U.S. federal tax rate. Other disadvantages for foreign individual partners include exposure to U.S. estate tax and current-year taxation of all profits in the foreign partner’s home jurisdiction.

4. Exit Strategy

Some franchise owners have a long-term investment horizon, while, for others, the strategy is rapid growth and then a sale of the business. If the latter strategy is adopted, tax planning may favor a structure generating a lower rate of capital gains tax over one that is more tax efficient with respect to the repatriation of profits. (See the previous discussion titled Tax on the Sale of the U.S. Franchise Business).

D. Investigate Tax And Other Incentive Programs

To promote certain social and economic objectives and encourage the relocation of businesses to their jurisdiction, many states offer tax and other incentive programs. These incentives typically are based on the level of employment that will be created in the state and include payment of employee salaries during on-the-job-training programs\textsuperscript{56}, reduction or abatement of personal or real property taxes for a period of years, low-interest forgivable loans for building improvements (e.g., for each employee added over the initial employment requirement, a significant amount of the loan is forgiven), and modifications to the federal gross income base for state income tax purposes.\textsuperscript{57} To the extent the foreign franchisor envisions

\textsuperscript{53} An LLC can also be considered, subject to the issues discussed above.

\textsuperscript{54} Taxation as a partnership generally is determined under I.R.C. § 7701.

\textsuperscript{55} I.R.C. § 1446(a).

\textsuperscript{56} E.g., Tennessee FastTrack Job Training Assistance Program at http://www.tnecd.gov/BD_FastTrack.html.

\textsuperscript{57} E.g., N.Y. TAX LAW § 210(12).
creating significant employment in the U.S., it should investigate available incentive programs before choosing a location for its operations.

VI. CORPORATE

A. Choice of Jurisdiction

Except for banks and railroads, the United States does not have federal laws relating to the organization of business entities. Business entities are organized under the laws of one of the 50 states, the District of Columbia, or Puerto Rico. Organizational requirements vary from state to state. For example, there may be differences as to the number and qualification of officers and directors. Fortunately for foreign franchisors, under almost every state corporate law there are no U.S. citizenship or residency requirements for directors and officers.

Unless there are U.S. investors, it is likely that the foreign franchisor will use a wholly-owned subsidiary for U.S. expansion. Governance issues will arise at the foreign parent level and be governed by foreign law. This means that many differences between state business entity laws, such as differences in the rights of minority owners, will be irrelevant. Choice of jurisdiction for a wholly-owned subsidiary will be influenced by the following factors. First, prospective managers, officers, and directors of the U.S. subsidiary will want to ensure that they are indemnified to the fullest extent possible. While most states adequately address this issue in their business entity laws, some jurisdiction shopping might be required. Second, some states have retained antiquated or unusual provisions in their corporation laws. For example, New York’s corporation law makes the 10 largest shareholders responsible for unpaid wages. Therefore, reviewing the proposed business entity law is warranted, even where the U.S. subsidiary is to be wholly-owned. Favored states for business entity formation include Delaware, Nevada, and the state where U.S. operations will be located:

1. Delaware

Nearly half of the corporations listed on the NYSE were incorporated in Delaware. It remains the perennial leader in incorporations in part because (i) its corporate law is continuously revised to make transactions easy to accomplish, (ii) the Secretary of State provides quick and efficient service regarding filings and other administrative matters, (iii) many U.S. corporate attorneys are familiar with Delaware law and will provide Delaware corporate law opinions for financings and other transactions, and (iv) it does not tax intellectual property or activities conducted outside of the state. Similar benefits are available for Delaware limited liability companies and partnerships. These factors make Delaware a very portable jurisdiction for business entity formation and ideal for a foreign franchisor whose operations may relocate over time or require multiple business entities operating in different parts of the country.

2. Nevada

Nevada also is a favored state for incorporation. Its popularity may relate more to the fact that it has no state corporate income tax than actual differences in corporate law. However, it is important to remember that a franchisor will avoid state income tax only to the extent it actually carries on business in Nevada. Other states will tax the Nevada corporation, if there is nexus. Some benefits touted by Nevada over Delaware include an increased level of anonymity. Nevada has not signed an information sharing agreement with the IRS, and its corporate law permits bearer shares. Nevada also offers potential franchise tax savings for corporations that require a high number of authorized shares (i.e., for a venture capital
financing). Sophisticated corporate directors may prefer the indemnification provisions and other director-related aspects of Nevada law.

3. Other

If a foreign franchisor's business plan calls for expansion into only one U.S. state (e.g., California), the franchisor may consider simply forming its U.S. subsidiary under that state's business entity statute. This choice eliminates the need to qualify the business entity to do business in the state where it plans to operate (see the following discussion).

B. Qualification To Do Business

Each U.S. state has a law requiring foreign corporations, limited liability companies, and limited partnerships to register or "qualify to do business," if they are doing business within the state (a foreign corporation, limited liability company, or limited partnership being any entity formed and organized under the laws of another U.S. state or foreign country). Foreign business entities qualify by filing an Application for Certificate of Authority in which they designate a registered office and agent for service for process within the state and pay a registration fee. Once qualified, the entity must file an annual report and pay its annual franchise tax to remain in good standing.

Unfortunately, there is no uniform definition of what constitutes doing business in a state. Therefore, one must review the relevant state statute and related case law to determine whether a foreign entity's particular activities within a state constitute doing business. Some state courts have held that the activities fundamental to franchising (soliciting franchise agreements, licensing intellectual property, approval rights or advice regarding choice of sites, training franchisees, and controlling business methods) do not constitute "doing business." One exception is in Texas, where a 1983 case held that basic franchising activities do constitute doing business. In other states, a franchisor will be required to qualify only if it exercises a great deal of control over the franchisee's activities (i.e., takes part in the hiring of the franchisee's employees) or carries on some other activity requiring qualification (i.e., opens a warehouse or branch office to facilitate local sales).

A company required to qualify to do business that has not obtained a Certificate of Authority is subject to payment of all past fees and taxes. It also may be required to pay a fine.

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59 E.g., New York Limited Liability Company Law, Art. 8, §802.
60 E.g., New York Revised Limited Partnership Act, Art. 8-A, §121-902.
63 See id. at 74 (citing Barbee V. United Dollar Stores, Inc., 337 So. 2d 1277 (Miss. 1976); Thaxton V. Commonwealth, 211 Va. 38, 175 S. I.E. 2d 264 (1970)).
In some states, the company's directors, officers, and agents also may be fined. Fines vary widely from state to state and may be as high as $5,000 per month.\textsuperscript{64}

At one time, if a company was not qualified when it entered into a contract with a party in the state, the company could not bring an action in the state's courts to enforce it. Today, although a company is prohibited from maintaining an action in the state's courts without being qualified, generally a company can qualify any time before filing suit and, in some states, even after it has filed suit.\textsuperscript{65} This is not the case in Alabama.\textsuperscript{66}

In most states, qualifying creates nexus for taxation by the state. Therefore, a foreign franchisor should be careful not to qualify its U.S. operating entity in a state where qualification is not required by applicable law.

C. Officer and Director Liability/Indemnification

Many states (including Delaware) have taken steps to protect directors from liability exposure by adopting provisions in their corporate statutes permitting corporations to limit their liability. In addition, most corporate statutes provide corporations very broad powers to indemnify directors and officers acting within the scope of their authority, except to the extent a person acts in bad faith, in a deliberately dishonest manner, or for his or her own personal gain. Despite these protections, some state and federal laws can impose personal liability in specific circumstances. Directors of U.S. corporations will want to understand these laws, ensure that the corporation carries adequate director and office liability insurance, and, where necessary, enter into an indemnification agreement with the corporation to expand on the limitations on liability and indemnification permitted by corporate law and embodied in the corporation's articles of incorporation and bylaws.

D. Capitalization

Capitalization means the amount of equity contributed by the owners in the business entity plus the amount of debt that it carries. There are three important concepts for franchisors related to capitalization: (1) the amount of capitalization that state franchise regulators may require (addressed below); (2) the use of debt to repatriate profits (addressed above); and (3) the concept of piercing the corporate veil.

\textsuperscript{64} Texas Business Corporations Act, § 8.18C.

\textsuperscript{65} CT Corporation Services, supra note 59, at 12.

\textsuperscript{66} Code of Alabama, 1975, § 10-2B-15.02(a). A foreign corporation transacting business in this state without a certificate of authority or without complying with Chapter 14A of Title 40 may not maintain a proceeding in this state without a certificate of authority. All contracts or agreements made or entered into in this state by foreign corporations prior to obtaining a certificate of authority to transact business in this state shall be held void at the action of the foreign corporation or by any person claiming through or under the foreign corporation by virtue of the contract or agreement; but nothing in this section shall abrogate the equitable rule that he who seeks equity must do equity.
In limited circumstances, U.S. courts will pierce the corporate veil and hold shareholders liable for the corporation's obligations.\textsuperscript{67} One factor courts review to determine if veil piercing is warranted is whether the corporation is grossly under-capitalized.\textsuperscript{68} The shareholders must ensure that the corporation has a reasonable amount of capital to make it financially viable. What is reasonable will depend on the financial needs of the particular business.

VII. FRANCHISE DOCUMENTATION

A. Franchise Agreement Preparation

The foreign franchisor entering the United States market must prepare franchise documents appropriate for the venture. Required documents consist of franchise-related agreements (and ancillary materials) and disclosure documents. Because franchise regulation in the United States is unique compared to virtually all other countries regulating franchising—disclosures mandated by federal and state laws in the United States are more comprehensive and technical than those mandated by non-U.S. laws—the foreign franchisor has no choice but to prepare a new Franchise Disclosure Document to comply with the federal franchise law and state franchise registration/disclosure laws.

However, the foreign franchisor has two main options when deciding how best to prepare the franchise-related agreements (and ancillary materials) necessary for entry into the U.S. market: (1) Adapt the franchise-related agreements (and ancillary materials) used in its home country (and perhaps in other foreign countries) for the U.S. market; or (2) prepare completely new sets of franchise-related agreements (and ancillary materials) for the U.S. market. There is no right or wrong approach; foreign franchisors entering the U.S. market have successfully employed both options. The foreign franchisor must consider what is most efficient and cost-effective and most expected by, and likely to appeal to, the pool of prospective franchisees it will seek to attract. The form and style of the foreign franchisor's home country franchise documents might be so uncommon to prospective U.S. franchisees that simply adapting them for the U.S. market will not overcome a U.S. prospect's discomfort with them. That assumes the documents already are written in the English language. Having to translate documents into English creates other issues making simple adaptation an unwise choice. The foreign franchisor wants the playing field to be as even as possible with domestic U.S. franchise systems to minimize its practical barriers to successful entry.

Irrespective of style and form, which are cosmetic issues, the foreign franchisor must evaluate carefully which substantive and procedural changes in its franchise documents are necessary for successful growth in the United States and to comply with U.S. legal requirements. The following lists certain issues that should be addressed:

1. Territory and Reservation of Rights

The foreign franchisor must consider whether U.S. franchisees will receive any territorial or exclusive rights and, if so, their breadth. Franchisors granting exclusivity typically commit at

\textsuperscript{67} See, e.g., Pepsi-Cola Metro Bottling Co., Inc., 754 F.2d 10, 16 (1st Cir. 1985) (where the court set out a twelve factor test).

a minimum not to operate or grant others to operate substantially similar units under the same brand the physical premises of which are located within the franchisee's territory. The franchisor might exceed this minimum commitment by not allowing others to conduct any competitive business within the franchisee's territory. Whatever the precise commitment, the foreign franchisor must learn how to size and define the franchisee's territory. Customary territories in the foreign franchisor's home market might make no sense in one or more parts of the United States. Should the territory be measured by a radius from the franchisee's outlet? An area encompassing a minimum working and/or living population? Should it be the same for all franchisees or depend on whether the franchisee will operate in an urban or suburban market? The foreign franchisor must adapt to the diverse nature of the U.S. market. Granting the wrong exclusive territory could impede the foreign franchisor's ability to achieve desired levels of market penetration.

The foreign franchisor faces a real dilemma: Does it grant no exclusive rights in the United States, even if it typically does so in its home country, because it is not yet sure how to translate its exclusivity practice for the U.S. market? Or, does the foreign franchisor grant exclusivity despite that reality, fearing it will be unable to make franchise sales in the U.S. market to franchisees expecting some form of exclusive rights either because the competition offers them or because they are unwilling to invest in an unproven concept in the United States without some protection?

The foreign franchisor concomitantly must determine whether the franchisee will have minimum performance obligations to maintain whatever exclusive rights it does receive and will be restricted from operating its business beyond its territory's boundaries. Depending on the franchise concept, the franchisee might be required to achieve minimum gross sales levels within its territory and prohibited from soliciting or making sales outside its exclusive territory or via certain distribution channels (for example, the Internet or at wholesale).

The foreign franchisor must determine which rights it will reserve in the franchisee's territory whether or not it has conferred any exclusivity, for example, rights to certain types of customers or to sell branded products through alternative distribution channels (such as the Internet, grocery stores, wholesalers, etc.).

2. Pricing Restrictions

The foreign franchisor will be familiar with its home country's antitrust or "competition" laws and how they impact the franchisor's ability to control franchisees' minimum and/or maximum resale prices. Competition laws outside the United States generally are more restrictive than their U.S. counterparts. This is especially true since the late 1990s, when the United States Supreme Court began easing pricing restrictions in the resale context, first with its 1997 decision in State Oil v. Kahn69, holding that maximum resale pricing no longer was per se (or automatically) unlawful and instead would be analyzed under the more permitting "rule of reason," and then with its 2007 decision in Leegin70, reaching the same conclusion with respect

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to minimum resale prices." The foreign franchisor must assess whether pricing controls it would prefer to, but cannot, implement in its home country should and can be implemented in the United States.

3. **Gross Sales/Net Revenue Definition**

Setting appropriate fee levels is one of the foreign franchisor’s most important tasks. The foreign franchisor must price its franchise opportunity fairly and competitively in order to attract qualified candidates yet sufficiently high to cover its support costs and generate a reasonable return. Part and parcel of this analytical process is ensuring that royalty fees, advertising fund contributions, and other recurring payments are calculated on the relevant revenue base. The foreign franchisor must ensure that the revenue base used in its home country makes sense for the U.S. market and that any reductions or exclusions from the revenue base are tailored for the U.S. market (for example, taxes collected from customers for payment to the appropriate taxing authority, customer refunds to the extent payments originally were included in the revenue base, gift card purchases but not redemptions, and the like).

4. **Training**

The procedures and contractual provisions for initial and ongoing training might not differ much from those used by the foreign franchisor in its home country. Initial training might be somewhat longer for a U.S. franchisee and complicated by required adaptations of the franchise concept and possibly language barriers. Furthermore, because the foreign franchisor and the franchisee might be located far from each other, initial training will involve more expense than in a domestic situation. Where will initial training occur? Must the franchisee’s personnel visit the franchisor for classroom and hands-on training? Are test and training outlets operated by the franchisor near the franchisee? What commitments will the foreign franchisor make to provide on-site and pre- and post-opening assistance and support in the United States? The foreign franchisor must determine whether training-related expenses will be covered by the initial franchise fee or reimbursed by the franchisee. Will royalties and service fees suffice to cover ongoing support costs? The foreign franchisor should bear in mind that expenses almost always will be higher than anticipated.

5. **Marketing and Advertising**

The foreign franchisor that has succeeded in its home market naturally will be inclined to stick to its original formula for success. Yet, the foreign franchisor undoubtedly will learn that some aspects of its domestic formula will not necessarily work or be optimal in the United States. Marketing and advertising programs might have to be re-structured. The foreign franchisor must carefully examine the market conditions in the United States to determine how best to position and advertise its product or service. The target audience and methods of appealing to that audience could be very different. In addition, the types, effectiveness, and costs of various advertising media must be reviewed given the number of anticipated franchised outlets and the financial projections for them.

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71 However, many state antitrust enforcement authorities are not enamored with the *Leegin* decision and have expressed their intent to continue challenging under the auspices of state antitrust law, where appropriate, minimum resale price fixing.
6. **Confidential Information and Non-Competition Agreements**

Virtually all franchise agreements have in-term covenants prohibiting the franchisee and its owners from having ownership interests in or performing services for competitive businesses during the franchise term. The definition of a "competitive business" varies among franchise systems. It should be broad enough to protect the franchisor's business interests and proprietary information yet sufficiently narrow to be enforceable. In-term covenants are broader and enforced more universally than post-term covenants. Post-term covenants are more limited.\(^2\) Courts will enforce these provisions only if they are reasonably limited in geography, duration, and scope of prohibited activities and necessary to protect the franchisor's legitimate business interests. They typically apply after termination, expiration, or transfer of the franchised business and within the market where the franchisee operated or, possibly, in other markets where the franchise system operates. The foreign franchisor must assess the scope of protection necessary in the United States and whether and how it differs from the protection sought in the foreign franchisor's home country.

The franchise agreement's nondisclosure provisions should identify the nature of the franchisor's trade secrets or other proprietary information, prohibit their disclosure and unauthorized use during and after the franchise term (except on a "need to know" basis), and require franchisees to obtain nondisclosure agreements from those having access to the proprietary information. The foreign franchisor must square its traditional confidentiality practices with those required and expected in the United States. This includes assessing whether any confidential information achieves "trade secret" status.

7. **Supplying the Franchise System**

The foreign franchisor must assess how best to supply the newly-established franchise system in the United States. Will the foreign franchisor use domestically-produced items and export them to the United States? Are all required "inputs" for the franchisees' operation available in the United States? What are the supply costs and logistics? Are the inputs proprietary so that the franchisor is best-served limiting manufacture or distribution to only a small number of sources? Can non-proprietary items be used to facilitate sourcing and control costs?

The foreign franchisor must determine its own role in supplying goods or services to franchisees. Will it be the designated or sole supplier of a particular product or service or just one of several approved suppliers? At a minimum, the foreign franchisor should participate in negotiating supply and distribution contracts for the benefit of its newly-established franchise base. Will the foreign franchisor have its U.S. franchisees play a greater role in the supply chain than one is accustomed to seeing? To the extent the foreign franchisor is involved directly in the supply chain, it must factor franchisee credit risk into its overall costs of doing business, especially in the current economic climate. The foreign franchisor also must consider terms and conditions of the sale of products and services, late charges or interest to be added to past-due accounts, whether the franchisor will require personal guarantees, and the like.

\(^2\) Even if more limited, certain state laws (e.g., California and Georgia) invalidate many of these covenants, in which case the franchisor must resort to other means to protect the market against a former franchisee turned competitor, such as reserving the right to purchase the franchisee's assets post-term.
Whether the franchisor or franchisees administer the supply process, there might be restrictions on the franchisees' sources of products, ingredients, materials, and supplies. Franchisees often will have to buy approved brands, from approved suppliers, or according to certain specifications. Suppliers might be limited to the franchisor, its affiliates, or unaffiliated designated sources or could encompass numerous approved suppliers. There are valid business reasons for these types of restrictions. The franchisor must control the image and quality associated with the franchise; standardization can promote operational efficiency for both the franchisor and franchisee; specification of sources might be necessary to protect the franchisor's trade secrets and confidential information; and restrictions might be a profit center for the franchisor or support efforts to maximize the system's purchasing power or cooperative advertising efforts with suppliers.

8. **Governing Law and Forum**

As in its home country, the foreign franchisor must determine which law will govern potential franchise disputes and where those disputes will be resolved. The foreign franchisor's natural reaction—that its own country's law should govern—might not work, even if the franchisor grants franchises directly into the United States rather than through a newly-established U.S. subsidiary or other affiliate. Choosing its own country's law will be resisted by U.S. franchisees, to whom that law will be completely unknown, and generally unenforceable in states with franchise registration laws. To expect a U.S. judge or arbitrator to be familiar or get acquainted with foreign law is unrealistic. Consequently, many foreign franchisors entering the United States will have the law of the franchisee's home state govern the parties' relationship. Where a U.S. affiliate is established to operate the franchise program, the franchisor alternatively might choose the law of the state where the affiliate was formed or has its principal business address.

The foreign franchisor faces identical decision-making on the forum for dispute resolution. Potential franchisees might not agree to adjudicate their disputes in a foreign country. Such a provision likewise generally will be unenforceable in states with franchise registration laws. Consequently, most foreign franchisors entering the United States will agree to resolve franchise disputes in the franchisee's home state or, where a U.S. affiliate is established to operate the franchise program, the state where the affiliate was formed or has its principal business address.

9. **Dispute Resolution**

The foreign franchisor entering the United States must decide whether to resolve the lion's share of franchise disputes in court or through arbitration. While the franchise agreement can select arbitration as the preferred dispute resolution vehicle, the franchisor should reserve the right to seek temporary and preliminary injunctive relief in appropriate circumstances to preserve rights immediately threatened. The site for arbitration proceedings often will be near the franchisor's principal place of business.

**B. Ancillary Agreements**

The Franchise Agreement (with a Guaranty and Assumption of Obligations) is not the only contract the foreign franchisor must create or adapt for its U.S. franchise program. Numerous other franchise-related agreements might be relevant for U.S. expansion (depending on the business being franchised) whether or not comparable agreements have been used in the foreign franchisor's domestic franchise program. Other franchise-related agreements
include: (1) Area Development Agreement/Development Rights Rider—for granting multi-unit rights; (2) Preliminary Agreement—to stage the process of granting the franchise and, in particular, to govern the prospective franchisee's selection of a suitable site before the franchise agreement is signed; (3) Deposit Agreement—to eliminate the "tire-kickers" by requiring prospects to show their seriousness by paying a portion of the initial franchise fee during the franchise investigative and evaluation process; (4) Franchisee Disclosure Acknowledgment—requiring franchisees to confirm, before they sign any binding agreements, that they did not receive and are not relying on unauthorized statements or materials when making their franchise investment decision; (5) Outlet Development Agreement—for the franchisor or its affiliate to assist in or control the process of developing the franchisee's unit; (6) Sublease; (7) Lease Rider/Collateral Lease Assignment—requiring specific terms in the franchisee's lease designed to protect the brand and preserve the franchisor's right to the site if the franchisee is evicted or the franchise relationship ends; (8) Principal's Agreement—requiring minority owners and other franchise executives to commit to specific non-monetary obligations in the franchise agreement (if they do not sign the standard Guaranty and Assumption of Obligations); (9) Software License Agreement—regulating the franchisee's use of the franchisor's proprietary software or similar technology; (10) Right of First Refusal Addendum; (11) Development Agent Agreement/Area Representative Agreement—if the franchisor uses third parties to solicit prospective franchisees, help franchisees find and secure acceptable locations, and assist franchisees in training and day-to-day operations in return for a share of the franchisees' initial franchise fee and ongoing royalties; and (12) Assignment and Assumption Agreement—when an individual franchisee wishes to assign its franchise rights to a newly-formed entity for convenience of ownership or an existing franchisee wishes to assign its franchise rights to an unaffiliated third party.

C. Operations and Training Manuals

In most franchise relationships, the business concept's essential know-how is manifested in one or more operations and training manuals. In a purely domestic franchise, the franchisor simply gives the franchisee access to its standard manuals. However, the foreign franchisor must do more when exporting its brand to the United States. It must adapt its brand for the U.S. market—this means critically assessing its operations and training manuals to determine which portions will remain intact or be modified to suit operations in the United States.

VIII. FRANCHISE DISCLOSURE DOCUMENT

Offering and selling franchises in the United States are heavily regulated. Of course, the primary jurisdictional issue is whether a particular distribution or license relationship in fact is a "franchise." Two sets of laws potentially apply to any product or service distribution structure bordering on being a franchise: the Federal Trade Commission's franchising trade regulation rule (the "FTC Rule") and various state statutes. Relationships meeting the federal definition of a franchise must comply with the FTC Rule whether or not they are "franchises" under state law. Similarly, relationships not falling within the FTC Rule's scope still must comply with applicable state franchise and business opportunity laws.

Under all franchise laws, a franchisor must deliver a franchise disclosure document ("FDD") to the prospective franchisee a minimum number of days before the franchisee signs any binding agreement (committing to the franchise relationship) or pays any monies (even fully refundable deposits). Disclosure seeks to ensure that a prospective franchisee has the information needed to make an informed investment/business decision before committing to the
business or paying any money. The disclosure regimen in the United States, considering it exists on both the federal and state levels, generally is more rigorous, technical, and detailed than the comparable rules in foreign countries. The FDD disclosure guidelines require a franchisor to disclose information in 22 specific categories. The following disclosure areas deserve special mention for the foreign franchisor entering the United States.

A. **Affiliated Network**

The franchisor must disclose (in Item 1 of the FDD) its own franchising and operating history, the franchising and operating experience of its predecessors, and the franchising and operating experience of any affiliates—including foreign affiliates—who will do business with U.S. franchisees or grant franchises in any line of business.\(^\text{73}\)

B. **Litigation**

The franchisor must disclose (in Item 3 of the FDD) certain types of legal proceedings in which it, certain affiliates, predecessors and/or executives are or have been involved. These disclosures include foreign litigation (and arbitration proceedings). Therefore, just as a U.S.-based franchisor must disclose certain foreign litigation in its domestic FDD, so too must a foreign franchisor entering the U.S. market, or the affiliate formed to conduct the franchise program in the U.S. market, disclose in its FDD foreign litigation involving certain people, entities, and claims.\(^\text{74}\)

C. **Bankruptcy**

As with litigation, the franchisor must disclose (in Item 4 of the FDD) certain types of bankruptcy proceedings in which it, certain affiliates, predecessors and/or executives are or have been involved. These disclosures include foreign bankruptcy proceedings. Therefore, just as a U.S.-based franchisor must disclose certain foreign bankruptcy proceedings in its domestic FDD, so too must a foreign franchisor entering the U.S. market, or the affiliate formed to conduct the franchise program in the U.S. market, disclose in its FDD foreign bankruptcy proceedings involving certain people and entities.\(^\text{75}\)

D. **Estimated Initial Investment**

The franchisor must disclose (in Item 7 of the FDD) the franchisee's estimated initial investment to develop and commence operating the franchised business. The foreign franchisor must adapt for the U.S. market its experience establishing units (both company-owned and franchised) outside the United States. It must critically assess the upfront initial investment costs that a U.S. franchisee is likely to incur. While the foreign franchisor's home country experience might be instructive, numerous variables particular to the U.S. market likely will challenge the relevance of that experience. The foreign franchisor must strike a delicate balance. Its estimated initial investment numbers cannot be too low—lest they be unrealistic and unattainable, serving only to alienate franchisees who rely on the numbers but experience

\(^{73}\) 16 CFR § 436.5 Disclosure Item (a).

\(^{74}\) 16 CFR § 436.5 Disclosure Item (c).

\(^{75}\) 16 CFR § 436.5 Disclosure Item (d).
much higher costs—nor too high—lest the franchisor scare potential franchisees into believing that the franchise costs too much and should be avoided in favor of less expensive alternatives, whether or not directly competitive with the franchisor’s offering.  

E. Rebates and Commissions

While required disclosures in Item 8 of the FDD about sourcing restrictions in the franchise system have no unusual application to the foreign franchisor entering the U.S. market, the franchisor must appreciate that it must disclose the precise basis by which the franchisor and its affiliates derive revenue from the supply chain must be disclosed. Therefore, if the franchisor was able to keep “secret” its rebate, commission, “kickback,” licensing, and similar arrangements with unaffiliated suppliers to the foreign franchise operations, it must be prepared to disclose in its FDD specific information about new U.S. arrangements (i.e., the actual dollar amounts it and/or its affiliates receive from suppliers on account of their dealings with U.S. franchisees and company-owned units or the percentage of gross revenue from those dealings that suppliers pay to the franchisor and/or its affiliates).

F. Trademarks, Patents, Copyrights, and Proprietary Information

As discussed earlier, the foreign franchisor must determine which intellectual property will be exported to the United States, whether that intellectual property is protectable in the United States, and what steps it should take to protect that intellectual property.

G. Financial Performance Representations

The foreign franchisor accustomed to disseminating freely to prospective franchisees in its home country (or in other jurisdictions outside the United States) information regarding the past or prospective financial performance of company-owned and/or franchised outlets is in for a rude awakening when expanding into the United States. These so-called “financial performance representations” (formerly known as “earnings claims”) are the most heavily regulated and often-abused area in franchising. This information is the most important area of inquiry for a prospective franchisee. While the franchisor is not legally obligated to provide this information to prospective franchisees, it must comply with stringent rules if it chooses to do so. The information must appear in writing in the FDD text and pass certain reasonableness, relevancy, and substantiation thresholds.

A financial performance representation is defined as “any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.” Excluded from this definition is cost or expense information given to a prospective franchisee. However, a franchisor may not

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76 16 CFR § 436.5 Disclosure Item (g).
77 16 CFR § 436.5 Disclosure Item (h).
78 16 CFR § 436.5 Disclosure Item (m).
79 16 CFR § 436.1(e).
disclose costs as a percentage of sales/revenue without including a financial performance representation in the FDD.

There are certain inflexible prerequisites for a franchisor desiring to prepare a financial performance representation. The franchisor must have a reasonable basis and written substantiation for the financial performance representation when it is made. The franchisor bears the burden of proving that it had a reasonable basis. The financial performance representation must state that written substantiation will be made available to the prospective franchisee on reasonable request and that a new franchisee’s individual financial results may differ from the results stated in the financial performance representation. The financial performance representation, which must be included in full in the FDD text, must include a description of the material assumptions underlying its preparation and presentation, including: (1) Whether the financial performance representation relates to the performance of all the franchise system’s existing outlets or only to a subset of outlets sharing particular characteristics (e.g., geographic location, type of location, degree of competition, length of time in operation, services or goods sold, services supplied by the franchisor, and whether the outlets are franchised or franchisor-owned and operated); (2) the dates when the reported financial performance level was achieved; (3) the total number of outlets that existed in the relevant period and, if different, the number of outlets with the described characteristics; (4) the number of outlets with the described characteristics whose actual financial performance data were used in arriving at the financial performance representation; (5) of those outlets whose data were used in arriving at the financial performance representation, the number and percent that actually attained or surpassed the stated results; and (6) characteristics of the included outlets that may differ materially from those of the outlet that may be offered to a prospective franchisee.

The foreign franchisor entering the U.S. market for the first time, and desiring to make a financial performance representation in its FDD, faces a critical threshold issue: Is it reasonable and relevant to use the financial performance information of brand outlets operating in the franchisor’s home country or elsewhere outside the United States? No franchise rule or regulation prohibits a franchisor from using this information. Indeed, but for the obligation to include certain caveats and language in Item 19 of the FDD, there is no prescribed manner or format for preparing a financial performance representation. Whatever information the franchisor provides must be described in detail and cover the required bases. It certainly is not hard to imagine that financial performance information for a brand operating in a country or market that is culturally, economically and/or otherwise similar to the United States would be relevant to prospective U.S. franchisees and reasonable to pass along. The franchisor wishing to disclose that financial performance information must ensure that all relevant background and explanatory information about the brand’s outlets outside the United States are provided in proper context.

H. Status of Brand Outlets

Item 20 of the FDD requires disclosure of the “census” of company-owned and franchised outlets operating under the franchise brand. However, unlike foreign litigation and bankruptcy proceedings disclosable in the FDD, disclosure of foreign outlets is not required but is permitted. The foreign franchisor might wish to disclose information about its foreign

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80 16 CFR § 436.5 Disclosure Item (s).
operations to show prospective U.S. franchisees that the franchise concept has viability, credibility, and acceptance, at least until it has established a sufficient U.S. presence and can rely exclusively upon a census of U.S.-based outlets.  

I. **Item 21 - Financial Statements**

1. **Disclosure of Parent Financial Statements**

Under the FTC Rule, the FDD must include separate financial statements for the franchisor, any subfranchisor, and any parent that commits to perform post sale obligations for the franchisor or guarantees the franchisee’s obligations. Parent is defined in the FTC Rule as an entity that controls another entity directly or indirectly through one or more subsidiaries. In its response to Frequently Asked Questions, FTC Staff elaborated on a parent’s commitment to perform post sale obligations and set out two distinct elements: (1) There must be an obligation to provide a good or service to the franchisee; and (2) the parent must commit to perform the obligation. The parent commits if it either assumes the obligation or the franchisor arranges for the parent to provide the good or service on its behalf.

2. **U.S. GAAP and GAAS**

Under the FTC Rule, required financial statements must be prepared under U.S. GAAP (generally accepted accounting principles) and audited under U.S. GAAS (generally accepted auditing standards). This is problematic for foreign franchisors because many foreign jurisdictions do not require that a franchisor’s financial statements be audited, and, even if audited statements are required, it is highly unlikely they would be prepared under U.S. GAAP and audited under U.S. GAAS.

3. **The “SEC” Exception**

The FTC Rule provides an alternative to the U.S. GAAP requirement that may be useful to some foreign franchisors. Financial statements prepared under a foreign country’s GAAP may be used if they meet U.S. Securities and Exchange Commission (“SEC”) requirements for the same. FTC Staff has summarized the SEC requirements. The financial statements must: (1) explain the material differences between the principles of U.S. GAAP and the foreign GAAP; (2) reconcile the statements with U.S. GAAP; (3) provide all additional disclosures required by

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81 16 CFR § 436.5 Disclosure Item (l).
82 16 CFR § 436.5 Disclosure Item (u)(1)(v).
83 16 CFR § 436.1(m).
85 16 CFR § 436.5 Disclosure Item (u)(1).
86 Id.
U.S. GAAP and SEC regulations;\textsuperscript{88} and (4) be audited under U.S. GAAS. In addition, the auditor must comply with U.S. standards for auditor independence. FTC Staff has further stated that "a Canadian or other foreign accountant or accounting firm may audit financial statements for Franchise Rule purposes if the accountant or accounting firm (1) is registered with the Public Company Accounting Oversight Board ("PCAOB"); and (2) recently audited one or more financial statements that have been filed with and accepted by the SEC.\textsuperscript{89}

Many larger accounting firms operating in Canada meet the SEC requirements, including having the requisite experience with SEC filers. For those Canadian franchisors with audited statements prepared under Canadian GAAP, reconciliation may prove less costly than having to provide audited statements in accordance with U.S. GAAP. In addition, Canadian GAAS is very similar to U.S. GAAS so that, in most cases, conversion to U.S. GAAS is seamless.

4. Avoiding Disclosure of Parent Financial Statements

It is quite common for foreign franchisors new to the U.S. market to rely heavily on employees of their domestic franchise operations to provide training, opening assistance, and marketing assistance to U.S. franchisees. If these employees work for the parent, the parent’s financial statements might have to be included in the FDD. Separating ownership of the foreign franchise operating company and the U.S. franchise operating company so that there is no parent/subsidiary relationship is one way to avoid parent financial statement disclosure.\textsuperscript{90} Under this structure, the ultimate owners hold their interests in the U.S. operating company either directly (in a flow-through structure) or through a holding company that does not own or hold interests in the foreign operating company (in a corporate structure). The foreign franchise operating company providing assistance to U.S. franchisees on behalf of the U.S. franchise operating company therefore is an “affiliate,” not a “parent.” FTC Staff has stated that Section 436.5(u)(1)(iii) of the FTC Rule requires disclosure of a non-parent affiliate’s financial statements only if the affiliate guarantees the franchisor’s obligations.

The FTC Staff has provided further leeway,\textsuperscript{91} opining that the disclosure of parent financial information is required only when the franchisor’s parent commits to perform post-sale obligations for the direct benefit of franchisees. Agreements between a franchisor and its parent for administrative and other services for the franchisor’s internal purposes do not trigger the parent financial disclosure requirement. Because the FTC Rule uses the plural “obligations,” the performance of a single or isolated obligation alone is insufficient to trigger the disclosure. Arguably, Item 21 parent financials disclosure is intended to cover formal arrangements between the parent and franchisor for the benefit of franchisees or formal arrangements directly between the parent and the franchisees. The performance of post-sale obligations by a parent’s

\textsuperscript{88} SEC Form 20-F, Part III, Items 17 and 18.

\textsuperscript{89} See FAQ #17 at http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml. Some registration states, e.g., Illinois, may ask for evidence that the foreign auditor complies with these requirements. This request may be satisfied by referring the examiner to the list of Registered Public Accounting Firms posted on the PCAOB website (http://www.pcaobus.org/Registration/Registered_Firms.pdf) and a letter from the auditor providing the names of SEC filers whose financial statements it has audited.

\textsuperscript{90} Care should also be given to avoiding a master franchisor and sub-franchisor relationship between affiliates.

\textsuperscript{91} See FAQ #16 at http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml.
employee for the benefit of franchisees does not trigger the Item 21 parent financial disclosures absent a formal commitment or guarantee on the part of the parent to perform. Franchisees must specifically look to the parent to provide the services (and not simply because an employee of the parent working for the franchisor provides the services).

IX. DISCLOSURE AND REGISTRATION IN THE UNITED STATES

A. FTC Rule Requirements

The FTC Rule, which applies in all states (and U.S. territories like Puerto Rico), requires that the FDD and all necessary attachments (including financial statements, various agreements, franchisee lists, operations manual table of contents, and the like) be delivered to the prospective franchisee (1) at least fourteen calendar days before the franchisee signs any franchise or other binding agreement with, or pays any consideration, fees, or deposits (even if fully refundable) to, the franchisor or an affiliate in connection with the proposed franchise sale, or (2) earlier than those fourteen calendar days if the prospective franchisee has "reasonably requested" earlier disclosure. There is no filing required with the U.S. federal government; the FTC Rule is simply a disclosure law. It is not acceptable to hold executed documents or checks "in escrow" until the fourteen calendar-day period elapses or to obtain a waiver of compliance. These waivers are invalid. In counting the number of days that have elapsed, franchisors may count neither the day on which the prospective franchisee receives the FDD nor the day on which the franchise or other binding agreement is signed or the consideration is paid, so that the prospective franchisee has a full fourteen calendar days in between (a true "sandwich" approach) to review the FDD.

The FTC Rule expressly allows franchisors to comply with their disclosure requirements by delivering the FDD in paper or electronic format, for example: by access to an Internet copy on a website; by email (in pdf format); on a computer disk or CD-ROM; or by fax. The key is that the FDD must be in a form permitting each prospective franchisee to store, download, print, or otherwise maintain the FDD for future reference. While franchisors may include scroll bars, internal links, and search features to enhance the prospective franchisee’s ability to maneuver through an electronic version of the FDD, all other features (for example, multimedia tools such as video, audio, animation, pop-up screens, or links to external information and websites) are absolutely prohibited. This prohibition ensures the integrity of the FDD—to prevent franchisors from calling attention to FDD portions they deem favorable and/or distracting prospective franchisees from less favorable disclosures.

An important requirement in the disclosure process is that, before giving the FDD to a prospective franchisee, a franchisor must advise the prospective franchisee of (1) the formats in which the FDD is made available (e.g., paper, CD-ROM, pdf, etc.), (2) any prerequisites for obtaining the FDD in a particular format (e.g., that the prospect is qualified to purchase the franchise and contacts the appropriate person or department), and (3) any conditions necessary for reviewing the FDD in a particular format (e.g., that the prospect needs to have a computer with email capability and Adobe Acrobat in order to read pdfs). This ensures that prospective franchisees know in advance whether they will receive the FDD in a form they can easily use and, if not, to request a format they can use.

The FTC Rule gives franchisors flexibility in communicating disclosure format information to prospective franchisees in any fashion they choose: in person; telephonically; in writing; through email; in franchise application forms; through marketing materials; by regular mail; on a website; or otherwise. However, the franchisor must be able to demonstrate that, in
fact, it provided this “format disclosure” before actually giving out the FDD (i.e., the prospect knew in advance the different formats in which the FDD would or could be made available).

It is not enough for franchisors to comply with the FTC Rule’s fourteen calendar-day rule; they also must be able to prove compliance. For this reason, franchisors must obtain a signed and dated “Receipt” from every individual or entity receiving a copy of the FDD. The FDD has duplicate Receipts (attached as the last two pages) used to confirm that the prospect received the FDD. It is essential that franchise prospects understand the importance of promptly dating, signing, and returning the FDD Receipt. The prospect should date and sign both Receipts. One Receipt must be returned to the franchisor; the prospect keeps the other Receipt. If there ever is litigation or another dispute, the original Receipt often is the most convincing proof that the franchisor delivered the proper FDD at the proper time. In counting the fourteen calendar days, the franchisor should count from the date on the Receipt, not from the date it actually delivered the FDD.

Under the FTC Rule, a franchisor is deemed to have furnished the FDD by the required date (i.e., the fourteen calendar days before a binding agreement is signed with, or monies are paid to, the franchisor or an affiliate) if (i) the FDD was hand-delivered, faxed, emailed, or otherwise delivered to the prospective franchisee by the required date, (ii) directions for accessing the FDD on the Internet were provided to the prospective franchisee by the required date, or (iii) a paper or tangible electronic copy (for example, computer disk or CD-ROM) was sent to the address specified by the prospective franchisee by 1st class U.S. mail at least three calendar days before the required date.

If franchisors deliver the FDD in an electronic format, they may use other means to obtain the franchisee’s “signature” confirming delivery of the FDD (besides return of the paper FDD Receipt). Under the FTC Rule, “signature” means a person’s affirmative step to authenticate his or her identity. It includes: a person’s handwritten signature; a person’s use of security codes or passwords; electronic signatures; and similar devices used to authenticate his or her identity. So, while there are two Receipt pages attached at the end of the FDD, the Receipts may be executed electronically. As with all disclosure protocols, however, the franchisor always must have the proper systems in place to capture proof of the electronic receipts not only for legal compliance (franchisors must maintain all Receipts for three years) but to defend any litigation claim that disclosure was not properly effected.

In addition to the fourteen calendar-day rule for delivery of the FDD, the FTC Rule requires that franchisors deliver the completed franchise-related agreements, i.e., those actually to be signed, to the prospective franchisee at least seven calendar days before the date on which the franchisee actually signs the documents but only if the franchisor has unilaterally made material changes (for the transaction) in the versions of the agreements attached to the FDD as exhibits. This seven calendar-day rule does not apply to changes resulting from negotiations prompted by the franchisee or to simple “fill-in-the blank changes” like name and address in the versions of the agreements attached to the FDD. The FTC Rule essentially gives a franchisee a final seven calendar-day “cooling-off” period during which it may consider the investment decision and review the final, ready-to-be-signed documents if the franchisor has unilaterally made material changes in them.

The FDD must be updated at least annually, generally (under the FTC Rule) within 120 days after the franchisor’s fiscal year end. This update includes preparing new audited financial statements for the most recently-completed fiscal year end. The FDD also must be updated during the fiscal year after a “material” change occurs. Generally speaking, any change in the
information contained in the FDD, or in the franchisor's business, reasonably likely to influence a prospective franchisee's investment decision probably is a "material" change. This is particularly true when there is an adverse material change. A franchisee acquiring a franchise on the basis of an FDD not reflecting a material change has ammunition or an "insurance policy" to use later if the business does poorly or fails and the franchisee wants to rescind the transaction and/or recover damages. Typical "material" changes include: (1) change (i.e., increase) in any franchise or other fee or initial expense specified in Items 5, 6, or 7 of the FDD; (2) a significant change in the franchisee's obligation to purchase items from the franchisor or designated sources, the franchisor's revenue from those purchases, and supplier payments to the franchisor or its affiliates; (3) adverse changes in the franchisor's financial condition; (4) adverse changes in the franchisor's right to use the primary trade or service marks, copyrights, or patents; (5) any major change in the franchisor's organization or operations; (6) the initiation against the franchisor and/or individuals disclosed in Item 2 of (and, once started, a change in the status of or claims made in) certain litigation or administrative matters (including arbitration); and (7) a change in the accuracy of financial performance information disclosed in Item 19.

B. Common Exemptions under the FTC Rule

The FTC Rule exempts certain relationships from the disclosure requirement even if a "franchise" exists.

1. Fractional Franchise

Fractional franchises are franchise relationships in which the franchisee, any of its current directors or officers, or any current directors or officers of a parent or affiliate has more than two years of experience in the same type of business, and the parties reasonably anticipate, when the agreement establishing the franchise relationship is signed, that the sales arising from the relationship will not exceed 20% of the franchisee's total dollar volume in sales during the first year of operation. The exemption's rationale is that the franchisee in a fractional franchise usually is familiar with the potential costs, profits, and problems of distributing similar goods and services and, due to the small percentage of its business attributable to the franchisor's goods or services, does not need the FTC Rule's protections.  

2. Sophisticated Franchisee Exemption

If the franchisee (or its parent or any affiliates) is an entity that has been in business for at least five years and has a net worth of at least $5 million.  

3. Large Investment Exemption

The franchisee's initial investment, excluding both financing received from the franchisor or its affiliate and the cost of unimproved real estate, totals at least $1 million, and the prospective franchisee verifies in writing the grounds for the exemption. This exemption applies only if at least one individual prospective franchisee in an investor-group qualifies for the exemption by investing at the $1 million threshold level. The rationale is that a prospective investor able to

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92 16 CFR §§ 436.1(g) and 436.8(a)(2).
93 16 CFR §§ 436.8(a)(5)(ii).
invest at least $1 million (not including franchisor financing and the cost of unimproved land) is likely to be sophisticated and able to make an investment decision without federal government intervention. However, that rationale does not apply when individuals, each investing only a small amount, combine in a group. Aggregating small investments of a group of individuals does not change those individuals into sophisticated investors. The same analysis applies to individual owners of an entity. To ensure that these owners are sophisticated, at least one individual owner must contribute at the $1 million threshold.  

4. **Insider Exemption**

This exemption is available for certain principals of the franchisor wishing to establish their own franchises and satisfying certain timing and experience requirements.  

C. **State Franchise Registration Requirements**

A franchisor generally may not offer or sell franchises in states with franchise registration laws unless and until it has complied with their registration or filing requirements and then complies with the disclosure obligations. This means that, until an effective registration or filing has been secured, no meaningful substantive contact of any kind, whether in person or by letter, email, or telephone, may be made with prospective franchisees in these states. In addition, no meaningful substantive contact should be made outside these states with any of their residents or with prospects contemplating buying franchises to be located or operated in these states. The reason is that the jurisdictional sections of the state franchise laws vary somewhat; disclosure obligations may arise when the franchisee lives in a state; the unit is to be located or operated in a state; a franchise offer is made or accepted in a state; or negotiations take place in a state. Fifteen states have enacted franchise registration and/or disclosure laws.  

A franchisor interested in offering and selling franchises in a franchise registration state must submit its FDD and other application materials (including a filing fee) to the particular state regulatory agency for review. Depending on the state, the franchisor might need to add, in advance, certain state-specific disclosures and/or modify certain portions of its franchise and

94 16 CFR §§ 436.8(a)(5)(i).  
95 16 CFR §§ 436.8(a)(6).  
96 Hawaii and Wisconsin stand alone in allowing pre-sale discussions even before the formal filings have been made.  
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*California
*Maryland
*North Dakota
*Virginia

*Hawaii
*Michigan
Oregon
*Washington

*Illinois
*Minnesota
*Rhode Island
Wisconsin

*Indiana
*New York
*South Dakota

In the eleven “asterisked” states, there is a formal filing process that requires registration of information in connection with the offer and sale of franchises. These eleven states require a franchisor to register its FDD with the state before soliciting interest in, offering, or selling its franchise in the particular state. On the other hand, Oregon does not have any special requirements. Michigan requires only the filing of a notice of intent to offer and sell franchises in the state (together with an annual $250 fee). While Indiana and Wisconsin require the filing of the standard FDD and certain application materials (together with an annual fee), they generally do not review the FDD.
other agreements to satisfy the particular state's law. The state review and approval process ranges from immediate (in states where filings are deemed to be effective upon receipt) to six to eight weeks. State franchise examiners may comment on the FDD if they believe it is deficient (by not addressing all required disclosure items or state-specific requirements).

Franchise registration states often evaluate a franchisor’s financial condition, reflected in its audited financial statements, to determine if the franchisor has the financial ability (in the franchise examiner’s opinion) to meet its initial contractual obligations to prospective franchisees. A state administrator has the authority to condition registration upon the franchisor’s demonstrating adequate financial capacity. If a state determines that the franchisor’s financial condition is questionable, either because it is a start-up business or has experienced operating difficulties, the state may impose conditions upon the franchisor before registering (either initially or in the renewal context) the franchise offering. For instance, the state may require the franchisor to place the franchisee’s initial payments in escrow. Generally, the funds will be released once the franchisee certifies that the franchisor has met all of its pre-opening obligations and the franchisee has begun operating its business. Alternatively, the state may (i) demand a surety bond to ensure the franchisor fulfills its obligations to franchisees within the state or (ii) require the franchisor to defer the franchisee’s obligation to pay the initial franchise fee and other amounts until the franchise opens for business. Most states will allow the franchisor to choose which financial assurance condition it prefers to use.

Several state franchise statutes continue to have their own special delivery requirements in terms of timing; the franchisor must comply with those delivery requirements when more stringent than those under the FTC Rule. For example, as of this paper’s preparation date, Maryland, New York, and Rhode Island still require that the franchisor deliver the FDD at the earlier of the first personal meeting held to discuss the proposed franchise sale but at least 10 business days before the franchisee signs any franchise or other binding agreement or pays any consideration, fees, or deposits (even if fully refundable) in connection with the proposed franchise sale. This was the pre-amended FTC Rule’s delivery requirement. Michigan and Washington retain only the 10 business-day delivery requirement. Similar requirements exist under a few business opportunity laws. However, on July 29, 2009, the North American Securities Administrators Association Franchise and Business Opportunity Project Group issued a “Notice of Request for Internal and Public Comment on Proposal for Uniform State Franchise Delivery Requirements,” proposing that NASAA adopt a policy statement recommending that states revise the FDD delivery requirements under their franchise laws to match the FTC Rule’s requirements.

Most franchise registration states require the registration of “franchise sellers.” This obligation is separate from whether certain persons need to be included in Item 2 of the FDD. A franchise seller means any person substantively involved in the franchise offer or sale and having material substantive contact with prospective franchisees, even if he or she is not, strictly speaking, in a “sales” position with the franchisor.

Any person or entity representing the franchisor in offering or selling franchises, but not an employee, officer, or director of the franchisor (or its affiliate), is deemed to be a “franchise broker.” While franchise brokers need not be disclosed in Item 2 of the FDD, they must be separately registered in certain states (New York and Washington) and filed as franchise sellers.

in other states. Franchise brokers must comply with the same disclosure rules with which the franchisor complies. A broker’s actions and statements are attributable to the franchisor because the broker acts as the franchisor’s agent in the franchise sales process. If the broker violates the law, the franchisor will be responsible.

Seven of the fifteen franchise registration states99 require franchisors to submit for review all franchisee recruitment materials (including advertising, sales brochures, franchise sales kits, CDs and DVDs about the franchise program, article reprints, etc.) before they are published or circulated, or sent to prospects, within the state. Filing these materials for review allows the states to ensure the consistency of the materials with the FDD, compliance with the state franchise laws, and the absence of prohibited representations (e.g., the investment is a safe investment, success is guaranteed, and the like). States allow franchisors to use the submitted materials after a specified amount of time has elapsed after they were filed (ranging from three to seven business days) as long as the state has not, in the interim, explicitly prohibited their use. Some state franchise laws require that certain minimum information or legends appear in the advertisement. One important exception to the advertising filing requirements is that “advertisement” under virtually all state franchise laws is defined to exclude communications circulated by the franchisor in a newspaper or other publication of general, paid circulation that, during the previous twelve months, had more than two-thirds of its circulation outside the particular state or a radio or television program originating outside the state that is received within the state. Consequently, advertisements run in a publication of national circulation, e.g., the Wall Street Journal (Eastern edition), USA Today, Franchise Times, and the like, need not be submitted to the states before they are run or distributed in the state—none of them have more than one-third of their circulation in any one state.

To avoid having their franchise system websites deemed to offer franchises before being qualified to do so, franchisors are well-advised to include a disclaimer at the beginning of the website portion discussing the franchise opportunity, and/or at the bottom of each page within the franchise opportunity tab, indicating that the franchise will not be offered within the franchise registration states until the franchisor has complied with applicable law. The franchisor also may not otherwise direct the offer into the state, and no franchise sales may occur until the franchisor complies with the state’s registration and disclosure requirements.100 Another benefit of including this website disclaimer is that it excuses the franchisor from having to file the website content with the franchise registration states as “advertising.” Obviously, the franchisor must ensure that its website’s content is consistent with the FDD and information presented in other media.

Exemptions from registration and disclosure under the state franchise registration laws include (though it varies from state to state) the large franchisor exemption for franchisors meeting certain minimum net worth and experience requirements; the sophisticated franchisee or large investment exemption; the fractional franchise exemption; the insider exemption; an exemption for sales of additional franchises to existing franchisees; and an exemption for sales by franchisees to others for their own account.

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99 The seven are California, Maryland, Minnesota, New York, North Dakota, Rhode Island, and Washington.

100 See NASAA “Statement of Policy Regarding Franchise Advertising on the Internet”—
http://www.nasaa.org/content/files/Franchise%5FAdvertising%5FInternet.pdf.
D. **State Franchise Relationship/Termination Laws**

Many states have relationship laws regulating the termination and non-renewal, or other substantive terms, of the franchise relationship. If, for example, a franchisor wants to send a formal default notice or terminate a franchise agreement, the applicable state law first must be reviewed to ensure that the franchisor’s actions meet statutory requirements. These requirements supersede the franchise agreement’s provisions.

E. **Business Opportunity Laws**

Business opportunity laws originally were designed to eliminate abuses in business arrangements like rack-jobbing and vending machine distributorships. The scope of these laws has expanded in many instances, however, due to inartful legislative drafting or judicial interpretation, creating additional compliance requirements for other types of business arrangements, including product distributorships and franchises. Business opportunity laws are similar to franchise laws in that they too generally require a business opportunity seller to file a disclosure document with the appropriate state administrator before offering the business opportunity in the state and to give that document to a prospective purchaser a certain number of days before the purchaser signs any contract or pays any consideration. Many of the laws go further by requiring a seller to post a surety bond, regardless of its financial capacity or accountability, include prescribed language in its business opportunity contract, and notify the purchaser of its right to cancel the contract for any reason within a certain number of days after it is signed.

Twenty-four states (including nine of the fifteen states with franchise registration/disclosure laws) have adopted business opportunity or “seller-assisted marketing plan” laws containing filing and/or disclosure obligations. These laws generally require disclosure to a potential investor contemplating buying goods or services to “start” (and, in some states, to operate or maintain) a business where the seller makes one of several representations to induce the purchase. The types of representations invoking a state’s business opportunity law vary from state to state. However, the following representations are typical: there is a market for the products; the purchaser will or can derive income or profit from the business opportunity exceeding its initial investment (generally phrased in terms of a “guarantee” and not a mere “representation”); and the seller will provide a sales or marketing program.

Even if one or more representations exist, numerous transactions (once again varying from state to state) are not covered by business opportunity laws. The rationale is that

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102 Alaska, Connecticut, Florida, Georgia, Iowa, Kentucky, Louisiana, Maine, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, Texas, and Utah. California, Illinois, Indiana, Maryland, Michigan, South Dakota, Virginia, and Washington also have business opportunity laws; however, compliance with a state’s franchise law, which usually is much stricter, obviates the need for compliance with (i.e., is an exemption from) the state’s business opportunity law.
registration and disclosure are not necessary to protect the investor due to the nature of the transaction, the seller, or the purchaser. The most important is the “trademark licensing” exception. Most states include the representation—"that the seller will provide the purchaser with a sales or marketing program"—as a representation invoking the state's statute. However, most statutes provide further that the law will not apply (absent other representations) to the sale of a marketing program together with the licensing of a registered trademark or service mark (sometimes expressly or by policy limited to federal trademark registrations). Where the seller makes no other representations—therefore providing no alternative bases for satisfying the definition of a “business opportunity”—the trademark licensing exception will exclude the relationship from the scope of the business opportunity laws. Other critical exemptions are the sale of a registered franchise (available in all states having franchise laws); transactions where the seller complies with the FTC Rule; relationships where the purchaser also deals in other goods or services not provided by the business opportunity “seller”; and transactions where the seller or buyer have certain minimum net worth.

X. IMMIGRATION

A. Use of Personnel from Home and Other Foreign Offices

Foreign franchisors may want to send personnel from their home or other foreign offices to the United States to set up and carry on franchise sales and operations. These executives, managers, and other employees must have proper work authorization to enter on a periodic basis or live in the United States.

B. Common Visa Types

The following temporary visa categories are commonly used by franchisors to facilitate movement of personnel to the United States. Other visa types may be available depending on the particular facts.

1. B-1 (Business Visitor)

The B-1 visa is designed to allow any individual to enter the United States temporarily to carry on limited activities for the benefit of his or her foreign employer. While in the United States, the individual must continue to be paid by the foreign employer, and the business activity must be associated with international trade or commerce. Under this classification, the individual cannot perform local employment that would displace a U.S. worker. The B-1 classification is often used by executives or managers of foreign franchisors to enter the United States to do certain preliminary work necessary to start up the franchise business in the United States. Such activities would include meeting with lawyers and accountants, opening bank accounts, and entering into contracts and leases on behalf of the U.S. company. The executive or manager, however, cannot be actively involved in managing the U.S. business without obtaining an appropriate work-authorized immigration status.

Generally, a business visitor must apply for a B-1 visa at a U.S. Consulate or, if a citizen of a country participating in the Visa Waiver Program (VWP), enter the United States for not more than 90 days without a visa. Canadian citizens are visa exempt and may apply for entry directly at a U.S. port-of-entry.
2. **TN (Trade NAFTA)**

The North American Free Trade Agreement contains provisions allowing certain Canadian and Mexican professionals to enter the United States under TN status to work for a U.S. employer. To be eligible, a person must demonstrate that he or she is a member of one of the professional occupations listed on a schedule in the Free Trade Agreement. Included in the list of professionals are accountants, engineers, scientists, physicians, architects, journalists, veterinarians, horticulturists, computer systems analysts, management consultants, and economists. Generally, if an individual's occupation does not appear on the list, or the individual does not have the specific degree or experience required, TN status would not be available. The TN visa is valid for up to three years with the ability to obtain three-year extensions. Spouses and children of holders of TN visas are admitted in H-4 or TD status, respectively. They cannot work in the United States unless they can independently obtain working visas.

3. **L-1 (Intercompany Management/Specialized Knowledge)**

The L-1 visa classification is available to individuals who have been employed by a foreign company outside the United States for at least one year during the preceding three-year period as an executive or manager (L-1A status), or person with specialized knowledge (L-1B status), and who seek to enter the United States temporarily to render services to a U.S. affiliate of the foreign company in one of these capacities.

To qualify as an executive or manager, the employee's duties must primarily involve directing the work of other managerial, supervisory, or professional employees or directing a key department or function of the company's business. First-line supervisors will not qualify unless the individuals they supervise are professional employees. A specialized-knowledge employee is one who has in-depth knowledge of the company's product, service, research, or equipment or an advanced level of knowledge of the company's processes and procedures. To be eligible for this classification, the foreign and U.S. operations must be affiliated. The company also must continue to do business in the United States and in at least one other country for the duration of the employee's stay in the United States.

The United States Citizenship and Immigration Services has special rules regarding "new office" situations. A new office is defined as an office in the U.S. that has been doing business for less than one year. To transfer an executive or manager under the L-1 classification to the United States to open a new office, the employer must initially show that the new office will support an executive or managerial position within one year and that the company has secured sufficient physical space in the United States to house its new office. The employer must submit information regarding the proposed number of U.S. employees and the positions they will hold and provide evidence of the size of the anticipated investment in the United States in terms of plant, equipment, inventory, staff salaries, etc.

L-1 status is issued for a three-year period (limited to one year initially in new office situations) with the possibility of obtaining up to four additional years of extension. L-1A executives and managers can obtain a maximum of seven years; L-1B specialized-knowledge employees can obtain a maximum of five years. The spouse and children of an L-1 employee are admitted in L-2 status. Spouses of L-1 status holders can apply for employment authorization through a regional office of the Immigration Service once they have entered the U.S. in L-2 status. Employment authorization is granted for the period of admission of the L-1 spouse, not to exceed two years, and can be renewed as long as the L-1 spouse maintains valid status.
4. **Treaty Trader (E-1 Visa) and Treaty Investor (E-2 Visa)**

Nationals of certain countries having treaties of commerce with the United States are eligible to apply for entry as treaty traders or treaty investors under the E visa category. The treaty trader (E-1) category is designed for companies or individuals who engage in a substantial amount of international trade (more than 50%) between the treaty country and the United States. The treaty investor (E-2) visa is designed for companies or individuals who invest, or are actively in the process of investing, substantial funds in a U.S. business. To obtain either treaty trader or treaty investor status, the U.S. business must have the “nationality” of the treaty country, meaning that at least 50% of the business must be owned by citizens of that country. Furthermore, each employee seeking to enter the U.S. in E-1 or E-2 status must be a citizen of the treaty country and an executive, supervisory employee, or an essential (highly skilled) employee.

A treaty trader applicant must show that he or she as the trader, or his or her employer as the trader, engages in a substantial amount of international trade between the treaty country and the United States. This means that the foreign franchisor must already be doing business in the United States either directly or through U.S. distributors or sales representatives. Though neither the Immigration Act nor the underlying regulations define “substantial” or set a minimum dollar amount, the adjudicating officer will look at (a) the volume of trade, (b) the number of transactions, and (c) the continued course of trade to determine substantiality.

A treaty investor applicant also must show that he or she has made a substantial investment in the U.S. business that qualifies for treaty investor status. There is no minimum dollar amount used to determine whether an investment is substantial. The amount of qualifying funds invested will be compared to the value or cost of the U.S. business to determine whether the investment is substantial. In applying this proportionality test, the adjudicating officer will require the investment to be a higher percentage if the value of the business is relatively low, and a lower percentage if the value is relatively high. The qualifying investment is measured by the amount the investor has “at risk” in the U.S. business. Indebtedness, such as mortgage debt or commercial loans secured by assets of the U.S. business, does not count toward measuring the amount of the investment “at risk.”

The investor must demonstrate that the U.S. business has the present or future capacity to generate a positive economic impact beyond providing a minimal living for the investor and his or her family. Factors considered in this determination include the number of jobs created by the investment and the extent to which the income generated by the investment exceeds an amount that would be considered sufficient to support the investor and his or her family. The investor also must demonstrate that he or she has the control necessary to develop and direct the U.S. business.

Treaty trader and treaty investor visas are generally valid for five years and may be extended in five-year increments. Spouses and children are admitted under the same status and spouses may apply for employment authorization through the Immigration Service.
XI. EMPLOYMENT

A. Establishing and Terminating the Employment Relationship - “At Will” Employment

Federal and state legislation detail the type of information that employers may solicit from job applicants and employees prior to and after hiring. Certain questions are prohibited altogether, while other questions are regulated as to form and content. Foreign franchisors should carefully train employees involved in U.S. based hiring.

The longstanding common law rule in most U.S. states is that, absent an employment agreement for a definite duration, the employment relationship is presumed terminable "at will," that is, it can be terminated by either party for good reason or for no reason at all. The employment-at-will presumption can be overcome by express or implied contractual limitations or in the case of employer fraud. ¹⁰³

A federal statute, the Worker Adjustment and Retraining ("WARN") Act and its state counterparts govern significant employment reductions. Unless a WARN Act applies, employees who are terminated in most U.S. states have no statutory entitlement to notice or severance. Employees may, however, be entitled to unused vacation and other compensatory time which is earned and unused at the time of termination. Executives and high level managers may request a written employment agreement, including a severance payment requirement.

B. Discrimination Claims

Federal laws and the laws of nearly all states prohibit discrimination based upon certain protected characteristics including age, sex, race, creed, color, national origin, disability, marital status, and military service. These laws are administered by the Federal Equal Employment Opportunity Commission and by state Human Rights Commissions. Regulations issued by these governmental entities and related case law detail the factors considered to be discriminatory. Discrimination claims are often made by employees upon at-will termination of employment. Developing employment policies and procedures is critical to avoid discrimination claims and defend against those that arise. For example, equal employment opportunity clauses and non-harassment policies in employee manuals provide an important defense to certain harassment and discrimination claims. Similarly, carefully drafted job descriptions are important to avoid liability under disability discrimination laws.

C. Workers’ Compensation Insurance

In most states, employers are statutorily required to obtain a workers’ compensation policy from a private insurer. State workers compensation laws also establish the mechanism for compensating employees who suffer a work-related illness or injury. They include detailed requirements regarding reporting and remedies for persons who are injured during job-related

¹⁰³ See, e.g., Rooney v. Tyson, 91 N.Y.2d 685, 697 N.E.2d 571, 674 N.Y.S.2d 616 (1998) (An oral contract for personal services between a fight trainer, Kevin Rooney, and professional boxer, Mike Tyson, to train Tyson for as long as [he] fights professionally was a contract for a definite duration and therefore, was not terminable at will).
activities. Workers’ compensation laws generally provide the exclusive remedy for employees who have been injured on the job.

D. **Payroll Services**

Most states in the U.S. have a variety of laws relating to the payment of wages, payroll deductions, and mandatory employer contributions, including unemployment and disability benefit insurance. Given the complexity of, and variations in, these laws in each state, using a professional payroll service company is often the best way to ensure compliance.

E. **Employment Eligibility Verification**

Every U.S. employer must complete and retain an I-9 Form for each employee working in the United States. The form provides a record of the employer’s review of documentation establishing that the employee has the right to work in the United States.

XII. **SUPPLY CHAIN ISSUES**

Foreign franchisors intending to supply their franchise system will need to review U.S. laws pertaining to the importation and sale of goods in the United States.

A. **Product Sales**

1. **Customs Issues**

   a. **Quota Restrictions**

   Quota restrictions, usually to protect established industries from foreign marketing pressures, exist for some products being imported into the United States.

   b. **Import Regulations**

   The entry of goods into the U.S. for commercial use requires arrival at a port of entry with the proper entry documents, payment of all estimated duties, and authorization by customs officials of delivery of the goods. Special import regulations may apply to certain goods such as agriculture commodities, foods, drugs, cosmetics, medical devices, pesticides and toxic and hazardous substances, textiles, wool, and fur products. Importing goods from certain countries is prohibited (e.g., Cuba, Libya, and Iraq).

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104 E.g., under New York Law, direct deposit of wages or salaries to a bank account may not be made without the advance written consent of the employee. New York State law also restricts the types of deductions an employer may make from an employee’s wages. New York State requires employers to provide and to pay taxes for Unemployment Insurance and Disability Benefit Insurance for certain categories of employees, and also to withhold small amounts from employees’ wages for such purposes.


106 For example, certain dairy products are subject to quotas administered by the United States Department of Agriculture. For a description of the various types of quotas, see http://www.cbp.gov/xp/cgov/trade/trade_programs/textiles_and_quotas/quota_restrict.xml.
c. **Duty**

Understanding specific customs requirements is essential to avoid inadvertently undervaluing and misclassifying goods. Penalties for mistakes can be quite onerous. Duty savings may be possible by properly structuring the transaction.

2. **Advertising and Marketplace Deception**

   a. **General**

   Section 5 of the FTC Act makes unfair or deceptive acts unlawful. Under FTC Advertising Guidelines, an advertiser must have a reasonable basis for objective product claims, whether such claims are express or implied. If a claim lacks adequate substantiation, it is considered deceptive. A "reasonable basis" is information that would satisfy a reasonable business person that the representation is true. The amount of substantiation required will depend on the type of claim. There is strict liability for violations of the FTC Act; no intent or evidence that consumers were actually misled is required. State Attorneys General and Consumer Protection Agencies are responsible for enforcing State Consumer Fraud and Deceptive Practices Laws ("Little FTC Acts"). Unlike their federal counterpart, consumers often have the right to sue under Little FTC Acts. Competitors also may have the right to sue for “unfair competition.”

   b. **Health and Safety Claims**

   The Federal Trade Commission focuses its enforcement actions on health and safety claims. A higher level of substantiation is required for health and safety claims. Competent and reliable scientific evidence is required.

   c. **Green Claims**

   Advertising statements about a product's or its packaging's environmental attributes also require a higher level of substantiation. Related laws, regulations, and guidelines have been enacted in many states.

3. **Warranties**

   If a franchisor decides to offer a written warranty on a consumer product to be sold by its franchisees, it must comply with the Magnuson-Moss Warranty Act. Written statements in sales literature regarding product performance may be deemed a warranty for purposes of the Act. The Act and the corresponding rules adopted by the FTC establish three basic requirements that may apply to a franchisor as warrantor: (1) It must designate a written warranty as either full or limited (all consumer products over $10.00 U.S.); (2) it must state certain specified information about the coverage of its warranty in a single and easy to read document (all consumer products more than $15.00 U.S.); and (3) it and the franchisee, as seller, must ensure that the warranty is available where the product is sold so that consumers can read it before buying (all consumer products more than $15.00 U.S.). There also is an Implied Warranty of Merchantability and an Implied Warranty of Fitness for a Particular Purpose for the sale of goods under the Uniform Commercial Code. The Magnuson-Moss Warranty Act prohibits anyone offering a written warranty from disclaiming these implied warranties.
4. Sales and Use Tax

Sales of goods and certain services are taxed at the state and local level. Combined state and local sales tax rates range from 0 to 9.4%.

Of particular interest to foreign franchisors who will sell products, such as equipment and uniforms, directly to U.S. franchisees is the concept of "Attributional Nexus." As states continue to lose money on out-of-state sales, they are becoming more creative in the theories used to subject remote vendors to sales tax. These alternative theories permit the states to assert jurisdiction over out-of-state vendors without sufficient physical presence to satisfy traditional nexus thresholds. States generally have taken two approaches. If an out-of-state taxpayer is so dominated by or interrelated with the in-state affiliate, the out-of-state taxpayer's separate existence may be ignored. The affiliated entities are viewed as one, giving the taxpayer nexus wherever its affiliate has nexus (Alter Ego Theory).

A company doing business in the state may, under appropriate circumstances, be deemed to be acting as the taxpayer's agent. In such cases, the agent's nexus is attributed to the taxpayer as though the taxpayer had performed the agent's activities (Agency Theory).

B. Application of the Uniform Commercial Code

Transactions for the sale of goods are governed by the Uniform Commercial Code (the "UCC") as adopted in the applicable state. If a U.S. subsidiary of the franchisor is purchasing directly from suppliers in the United States, the UCC will apply. The United States is party to the United Nations Convention on Contracts for the International Sale of Goods. If a U.S. subsidiary of the franchisor is purchasing directly from international suppliers, the Convention will apply unless its application is waived in writing between the parties to the sale.

C. Labeling

U.S. importers are responsible for properly marking imported merchandise. The United States Customs Service is charged with enforcing the regulations of approximately 40 other agencies, each of which has its own guidelines concerning marking and labeling. The type of

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109 See, e.g., Franklin Mint Corp. v. Tully, 94 A.D.2d 877 (3rd Dep't 1983), aff'd without opinion 61 N.Y.2d 980 (1984) (subsidiary had nexus with New York based upon the New York parent's ownership of the subsidiary). Separate and Distinct Entities Can Avoid Attributional Nexus - if activities are separated and all transactions are at arms length, the use of separate entities can serve as a viable planning option. See Bass Pro Outdoor World, LLC, TSB-A-03(29)S (June 11, 2003); see also NADA Servs. Corp., ALJ (Feb. 1, 1996), Spencer Gifts, TSB-A-85(37)S.


111 E.g., the FTC Act requires that the country of origin be identified on all products imported into the U.S. with the words: "Made in ___________" or "Product of ________________".
products involved will govern the regulations that must be satisfied.\textsuperscript{112} There are no restrictions on foreign language information appearing on labels provided the required information appears in English.

\section*{XIII. MISCELLANEOUS}

\subsection*{A. Industry Specific Requirements}

Many states have licensing and certification requirements for specific activities.\textsuperscript{113} Certain licenses will be issued to foreign citizens only if they are holding particular types of visas. For example, a Canadian franchisor considering setting up a test restaurant in New York State needs to know that a liquor license applicant must have either a permanent visa or an E-2 Treaty Investor or L-1 visa.

\subsection*{B. Insurance}

Since 9/11, it has become increasingly difficult to obtain certain types of insurance at reasonable rates. Foreign franchisors should consider consulting with a U.S. risk management firm to determine (a) what types of coverage are needed, (b) the amount of coverage that is appropriate for the U.S. market, and (c) where such coverage can be obtained at a reasonable price. In order to get a reasonable price, it may be necessary that all coverage be placed with the same carrier, and the foreign franchisor’s current carrier may not be able to write certain U.S. coverage (\textit{e.g.}, workers’ compensation). Certain U.S. carriers offer coverage that is specific to the franchise industry. This coverage is known as Professional Liability Coverage and insures franchisors against certain claims that may be brought by franchisees.

\subsection*{C. U.S. Economic Sanctions}

Once a foreign franchisor establishes operations in the United States, it becomes subject to U.S. laws governing extra-territorial business dealings. For example, the Department of the Treasury’s Office of Foreign Asset Control administers comprehensive economic sanctions, including trade embargos, against specific countries and administers prohibitions against dealing with a published list of suspected terrorists. Sanctions are severe, providing for up to 10 years imprisonment and fines of up to $250,000 for individuals and $1 million for companies. The activities of a foreign parent or subsidiary may be ascribed to a U.S. entity as the regulations forbid a U.S. company from approving, financing, insuring, or otherwise facilitating activity that would be covered by the prohibitions if performed by a U.S. person.

In accordance with Internal Revenue Service Circular 230, we advise you that, unless otherwise expressly stated, any discussion of a federal tax issue in this communication is not intended to be used, and it cannot be used, for the purpose of avoiding federal tax penalties.

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\textsuperscript{112} \textit{E.g.}, Textile Fiber Products Identification Act; Wool Products Labeling Act; Fur Products Labeling Act; Federal Hazardous Substances Act; and Food, Drug and Cosmetic Act.
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\textsuperscript{113} \textit{E.g.}, architecture; certified shorthand reporting; engineering; contractors; interior design; land surveying; landscape architecture; attorneys; public accountancy; social work; and a wide variety of health related professions.
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GEORGE J. EYDT

George J. Eydt is a partner in the U.S. law firm Hodgson Russ LLP. He is resident in the firm’s Toronto office. Mr. Eydt regularly counsels Canadian and International companies on business expansion into the United States with a primary focus on franchise and distribution law, mergers and acquisitions, and the creation of branch and subsidiary operations. His franchise practice encompasses a broad range of activities, including (i) drafting and reviewing franchise disclosure documents, franchise agreements, and other ancillary documents, (ii) state registration of franchise disclosure documents, including preparation of state addenda and amendments and negotiation with state regulators, (iii) providing advice regarding franchise law exemptions and exceptions, and (iv) providing general legal advice to new and mature franchise systems. Mr. Eydt has counseled a broad range of Canadian and U.S. based franchise companies on U.S. legal issues, including both private and public companies.
STUART HERSHMAN

Stuart Hershman is a partner with the law firm of DLA Piper LLP (US) in Chicago, Illinois, and has focused his practice in the franchising, general dealership and distribution, and antitrust areas for close to 25 years. Mr. Hershman received his B.A. degree in history with high distinction from the University of Michigan in 1981 and his J.D. degree cum laude from the University of Michigan Law School in 1984. He has authored, co-authored, and contributed to numerous articles and seminar materials on various franchising, distribution, and antitrust topics, including the ABA’s “Financial Performance Representations: The New and Updated Earnings Claims” (co-editor and co-author); the ABA’s “Fundamentals of Franchising” (co-author); “Revisiting the Robinson Patman Act in the Franchise Supply Setting”; “The Bona Fide Wholesale Price: How Safe is this Harbor?”; “Information and Switching Costs in the Franchise Context: Does Kodak Affect Franchisors Complying with the New Uniform Franchise Offering Circular Guidelines?”; “Supreme Court Breathes Life into Derivative Market Tying Claims”; and “Federal Antitrust and Trade Regulation Law: Problems and Concerns in Franchising.” Mr. Hershman has spoken at the ABA Forum on Franchising, the International Franchise Association’s Legal Symposium and Legal Roundtables, and other franchise-related seminars. He is recognized in the International Who’s Who of Franchise Lawyers, the International Who’s Who of Business Lawyers, Franchise Times’ “Legal Eagles,” the Illinois Leading Lawyers Network, and Illinois Super Lawyers.