FRANCHISING IN THE UNITED STATES:
Land of Opportunity

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The United States is the land of opportunity for franchising – opportunity for tremendous successes and opportunity for spectacular failures.

THE U.S. MARKET

The United States is a huge market, with a population of more than 290 million. This large, sophisticated consumer base has disposable income and free time. This market is a giant, attractive target for most businesses.

U.S. FRANCHISE HISTORY

Franchising has enjoyed a relatively long and enormously successful history in the United States. Some authorities attribute the origins of franchising to the United States when I.M. Singer & Company sold exclusive territories to its sewing machine salesmen beginning in the 1850’s. In the 1890’s automobile manufacturers and gasoline refiners established dealer networks that began to resemble the modern franchise, but were still product distribution systems. Perhaps the first business format franchise was created in the 1930’s, when Howard Johnson licensed to an investor the right to open an ice cream shop using Johnson’s successful model.

The U.S. is home to some of the most recognized franchise brands in the world. McDonald’s, for example, now probably the largest single-system franchisor in the world, was founded in 1948 in California. McDonald’s granted its first franchise in 1954, and the first McDonald’s franchise unit opened in Illinois in 1955. Over the last 45 plus years McDonald’s has enjoyed remarkable success. It now has more than 30,000 units in 118 countries. Other major successes include:

- 7-Eleven convenience stores was established in 1927, began franchising in 1964, and now has about 21,900 franchised units and about 2,500 company-owned units;
- Subway was established in 1965, started franchising in 1974, and now has approximately 19,000 franchised submarine sandwich shops;
- Burger King (McDonald’s primary rival in the U.S.) was established in 1954, began franchising in 1961, and now has more than 11,350 units, about 90% of which are franchised;
- KFC (formerly known as Kentucky Fried Chicken) was established in 1930, began franchising in 1952, and now has about 11,000 fried chicken fast-serve restaurants, two-thirds of which are franchised.
Franchising is a vibrant and popular method of doing business in the United States. Noted thinker and author, John Naisbitt, has stated: “Franchising is the single most successful marketing concept ever.” It is certainly well-established in the United States – from the major metropolitan areas and suburbs to small town America. It is common for entire retail areas in the U.S. to feature nothing but franchises.

FRANCHISE STATISTICS

According to the International Franchise Association, there are more than 1,500 franchisors in the United States with approximately 320,000 franchised units domestically. One of every 12 business established in the U.S. is a franchise. A new franchise unit opens in the U.S. about every 8 minutes of every business day. More than 40% of all retail sales in the U.S. are made by franchises, representing more than $1 trillion in annual sales.

DIFFICULTIES WITH FRANCHISING IN THE U.S.

Not everything about franchising in the United States is favorable. International franchisors entering the U.S. must be aware of the difficulties, such as competition, distances, regional variations, locations, labor force, multi-level bureaucracy, franchise regulations, structuring the franchise and other impacts on franchising. Some foreign companies interested in breaking into the U.S. franchise market have opted to purchase existing U.S. franchises, rather than bring a foreign franchise into the country. Some of the best-known American franchised brands are now foreign-owned: Dunkin’ Donuts and Baskin Robbins are owned by Allied Domecq (UK); 7-Eleven is owned by Ito Yokado (Japan); Holiday Inn is owned by Bass PLC (UK); Motel 6 is owned by Accor (France); and a number of the best-known frozen yogurt franchises are all owned by Yogen Fruz (Canada).

COMPETITION

Many market segments in the United States appear saturated. For example, there is fierce competition between national franchisors in the pizza carry-out and delivery business. Pizza Hut, Pizza Inn, Domino’s Pizza and about 50 other franchise chains and thousands of independent pizzerias appear to have saturated the U.S. market. The situation in the pizza business was about the same in 1985. But – in America there always seems to be room for one more. In 1985, a new franchisor, Papa John’s Pizza, started a take-out pizza business, and in 1986 it began franchising. Papa John’s now has approximately 3,000 restaurants, 80% of which are franchised. This example demonstrates that Americans are very interested in new things, and that new franchises with new concepts and quality services or products can succeed, even in the face of strong, established competition.

LONG DISTANCES

People form other parts of the world often under-estimate the vastness of America. The area of the United States is approximately 3.7 million square miles or 9.5 million square kilometers. This is roughly 27 times the size of Germany, 21 times the size of Sweden, 29 times the size of Norway and 39 times the size of the UK. To help put this into perspective, the distance from New York City on the east coast to Los Angeles on the west coast is approximately 3900 kilometers – about the same as the distance from Munich to Baghdad.
Lisbon to Minsk, Stockholm to Rome, Oslo to Rome or Dover to Bucharest. These long distances dramatically impact many aspects of the business.

For this reason, a common expansion philosophy involves carefully selecting a particular area of the country for the first units, and then spreading out in concentric circles. By initially focusing on a small part of the U.S., the franchisor can maximize the impact of advertising in the area, minimize distribution costs and problems and minimize travel time and expense. Once a franchisor is established in the United States, the U.S. can serve as the base for expansion into Canada, Mexico, Central America and South America.

REGIONAL VARIATIONS

There is not a single, homogeneous U.S. market. The country is a melting pot of different cultures, races and religions. For example, about 75% of the population is Anglo, 12% is Black, 13% is Hispanic and 4% is Asian. More than 11% of the current U.S. population was born elsewhere, with about 7.9 million from Mexico, 1.2 million from the Philippines, 1.4 million from China, and 0.95 million from Cuba. Other significant sources of the immigrant population include India, Vietnam, El Salvador, Canada, Korea, and the Dominican Republic. Americans have diversion religious preferences, with 56% Protestant, 28% Catholic, 2% Jewish, 4% other and 10% none.

American demographics can vary dramatically from region to region. For example, the racial mix in Atlanta in the Deep South, Boise in the Midwest, San Antonio in the Southwest, and San Francisco on the West Coast is as follows:

<table>
<thead>
<tr>
<th></th>
<th>ATLANTA</th>
<th>BOISE</th>
<th>SAN ANTONIO</th>
<th>SAN FRANCISCO</th>
</tr>
</thead>
<tbody>
<tr>
<td>ANGLO</td>
<td>31%</td>
<td>92%</td>
<td>32%</td>
<td>44%</td>
</tr>
<tr>
<td>BLACK</td>
<td>61%</td>
<td>1%</td>
<td>7%</td>
<td>8%</td>
</tr>
<tr>
<td>HISPANIC</td>
<td>6%</td>
<td>5%</td>
<td>59%</td>
<td>17%</td>
</tr>
<tr>
<td>ASIAN</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
<td>31%</td>
</tr>
</tbody>
</table>

Even within a single state, the racial and cultural mix greatly varies from city to city, as do the economic conditions. Dallas and El Paso are both in Texas, but the differences in the racial makeup and economy of each city are significant:

<table>
<thead>
<tr>
<th></th>
<th>DALLAS</th>
<th>EL PASO</th>
</tr>
</thead>
<tbody>
<tr>
<td>UNEMPLOYMENT</td>
<td>4.3%</td>
<td>5.1%</td>
</tr>
<tr>
<td>PER CAPITA INCOME</td>
<td>$22,183</td>
<td>$14,388</td>
</tr>
<tr>
<td>ANGLO</td>
<td>35%</td>
<td>18%</td>
</tr>
<tr>
<td>BLACK</td>
<td>26%</td>
<td>3%</td>
</tr>
<tr>
<td>HISPANIC</td>
<td>36%</td>
<td>77%</td>
</tr>
</tbody>
</table>

Just because a concept works in Miami does not necessarily mean it will work in Boston. Concepts that are successful in the big cities might not be viable in small towns.
LOCATIONS

Because of the long history of franchising in the United States, most of the prime retail sites are already occupied. This has been one of the factors giving rise to the co-branding phenomenon. In particular, prime sites in existing shopping malls are difficult to obtain for an unknown company. Thus, new franchises are often left with low-traffic locations in existing malls, or are put in new malls or other retail locations.

EMPLOYEES

Entry-level employees can be difficult to find in some areas. The food-service industry, in particular, has been especially affected. Consequently, many franchises are providing increased wages and other benefits to attract and retain trained employees.

MULTI-LEVEL BUREAUCRACY

The American system of government has three layers of regulations: local, state and federal. These regulations can affect various aspects of franchises, such as: licensing of certain industries and professions, taxation (sales, use and income), construction of the premises, employment, minimum wages, consumer protection, maximum interest rates, landlord-tenant relationships, and others.

FRANCHISE REGULATIONS

Introduction. United States franchise laws are rather complex. There are two separate legal schemes that affect franchises in the United States: federal law and state law. Additionally, there are two separate types of regulations potentially applicable to franchises: franchising regulations and business opportunity regulations. Although business opportunity laws are not designed to regulate franchises, they are broad enough in some states to include franchises. Finally, there are three types of regulatory schemes: (1) regulations governing the pre-sale registration of franchises; (2) regulations governing pre-sale disclosure to the prospective franchisee or business opportunity purchaser; and (3) regulations governing the ongoing franchise or business opportunity relationship between the parties.

Before addressing the general requirement of federal and state franchise and business opportunity laws, it is important to understand their applicability.

Application. As a general rule, a foreign franchisor selling franchises or master franchises for territory in the United States, or to U.S. residents, will be required to comply with applicable franchise and business opportunity laws. It will also generally be necessary for a master franchisor or a subfranchisor to comply with the applicable laws. No matter which state in the U.S. the franchise relates to, it will be necessary to comply with federal law. In addition to the requirements of federal law, the franchisor must also meet the requirements of applicable state law. Again, the relevant states are generally those in which the franchised units will be located, and those states in which the franchisee is a resident.

Federal Franchise Law. The Federal Trade Commission (FTC) is the federal regulatory agency with jurisdiction over franchises and business opportunities. Under the FTC’s
regulations, the franchisor must provide a disclosure document containing 23 items of information described in plain English to prospective franchisees and business opportunity purchasers before a franchise or business opportunity is sold. The FTC regulations do not provide for federal registration of the franchise or filing of the disclosure statement, and they do not regulate the substantive terms of the franchise relationship. Although there are several limited exceptions to the FTC’s disclosure regulations, these exceptions are generally not applicable to franchise systems.

There are two permissible formats of disclosure under federal law: the FTC format and the Uniform Franchise Offering Circular (UFOC) format. For the reasons discussed below, the vast majority of franchisors in the U.S. use the UFOC format.

**Federal Business Opportunity Law.** The federal business opportunity law does not apply to franchises covered by the federal franchise law. It is designed to apply only to non-franchise business opportunities. Thus, only quasi-franchises need to be concerned about the federal business opportunity law. Because the disclosure burden under the federal law for a business opportunity is the same as for a franchise, there are no benefits under federal law to being one versus the other.

**State Franchise Law.** In addition to the federal FTC Rule, about 15 states have some type of franchise registration and disclosure laws, and about 20 states have some type of franchise relationship law. These states do not have uniform regulations in this regard. However, the governmental regulatory agencies in all of these states have approved the use of the UFOC format; therefore, most franchisors use the UFOC format. Like the FTC format, the UFOC format requires the pre-sale disclosure of 23 items regarding the franchise.

In short summary the topics are:

1. the franchisor;
2. the business experience of the key people;
3. litigation history;
4. bankruptcy history;
5. initial franchise fee;
6. other fees;
7. initial investment;
8. restrictions on sources of supplies;
9. franchisee’s obligations;
10. financing;
11. franchisor’s obligations;
12. territory;
13. trademarks;
14. patents and copyrights;
15. franchisee’s obligations to participate in the business;
16. restrictions on what the franchisee may sell;
17. renewal and terminations;
18. public figures;
19. earnings claims;
20. list of outlets;
21. financial statements;
22. required contracts; and
23. receipt of delivery.

A more detailed description of the required disclosures is attached.

State relationship laws vary greatly among the relevant states. Generally, they regulate matters such as good faith requirements, anti-discrimination between franchisees, permissible grounds for termination or non-renewal of the franchise, and required notice and cure periods for most defaults. Because of the differences in state registration, disclosure and relationship laws and regulatory policies, it is often necessary to attach state-specific addenda to the UFOC in order to comply with state law and to gain registration.

**State Business Opportunity Law.** About 25 states have laws requiring registration and disclosure in connection with business opportunity sales. The laws of most states with business opportunity regulations expressly provide an exemption for franchises; however, the exemption is generally subject to certain conditions, and some states require the filing of additional documentation in order to obtain the exemption.

**State Registration Process.** The state registration process for franchises and business opportunities varies among the relevant states. In some states, the filing of a one-page form is all that is required to register a franchise, and the registration will be effective the day the state office receives the form. In other states, the registration process involves the submission of certain forms to the state office, along with a copy of the proposed disclosure document with all of the required attachments (including the form franchise agreement). The state regulators in these states then examine the submission to determine whether it complies with state law, and they issue comments as to any perceived deficiencies. The franchisor then has a certain period of time to comply with the comments by revising the documents or providing additional information to the state regulators. In these states, the franchise registration does not become effective until the state regulator grants approval. This process may take several months, depending on the particular state and the condition of the original submission.

**STRUCTURING THE FRANCHISE**

The contractual structure franchisors typically use in expanding operations internationally include direct franchise agreements, area development agreements, or master franchise agreements. Which structure a franchisor ultimately chooses depends upon several factors, including the franchisor’s resources, the amount of control the franchise system requires to ensure high quality, and whether the training requirements can be delegated to persons other than the franchisor.

**Direct Franchise Agreement.** Direct franchise agreements provide for the grant by the franchisor to the franchisee of the right to open one franchise unit. Direct franchise agreements involve a high level of involvement by the franchisor, from selecting the franchisees to providing all the training and advertising.
**Area Development Agreement.** Area development agreements are a type of direct franchise relationship under which the franchisor grants the franchisee the right to develop multiple units in a designated territory. Each unit is governed by a separate franchise agreement. As with the single unit direct franchise relationship, the franchisor exercises all control to enforce system standards and procedures and is responsible for training and advertising. However, because each franchisee is developing multiple units, the franchisor may have a smaller number of franchisees than under a straight direct franchise agreement. The area development structure is not only popular among new franchisors for rapid expansion of their concept, it is the most common method in the United States for franchise expansion.

**Master Franchise Agreement.** Under a master franchise agreement, the franchisor grants the master franchisee the right to open units, as well as the right to subfranchise, or seek other franchisees to operate individual units. The franchisor thus passes on to the master franchisee the obligations of training the subfranchisees, developing the territory, and enforcing the franchise standards and procedures in exchange for a percentage of the initial fees and royalties paid by the franchisee to the franchisor. The master franchise arrangement allows a franchisor to expand without great resources due to its reliance on the resources of the master franchisee. The master franchise structure is most often utilized in international expansion when franchisors seek out master franchisees for entire countries. For foreign franchisors seeking to expand into the United States, a single master franchisee arrangement would not be feasible due to the size of the United States.

**OTHER IMPACTS ON FRANCHISING**

Companies looking to expand their operations into the United States through franchising should also consider various trade related issues. Products brought into the United States from outside the country may be subject to tariffs. Furthermore, restrictions governing imports into the United States have become more stringent since the events of September 11, 2001, as manifested by changes in legislation and the creation of a new U.S. Department of Homeland Security.

**North American Free Trade Agreement.** The North American Free Trade Agreement (NAFTA) between the United States, Canada and Mexico provides common rules for international trade and other transnational economic activity. NAFTA impacts much more than international trade in goods, including coverage for foreign investment, competition policy and intellectual property. The goal of NAFTA is to eliminate tariffs and facilitate trade between the United States, Canada and Mexico. The favorable treatment offered by NAFTA is restricted to goods produced in the member countries.
RECOMMENDATIONS

1. As with any international franchising effort, evaluate the U.S. market thoroughly before entry. Franchisors who enter the U.S. without doing so risk a costly and embarrassing failure, which could jeopardize the entire system. The pre-entry research should include full market research, analyzing factors including local market variations, competition, initial target areas, site availability, labor pool, supplies, applicable regulations, management and support.

2. Plan for the initial start-up costs – and then some. International expansion always takes longer and costs more than originally planned, so be prepared.

3. The start-up process can be accelerated, and costly mistakes can be avoided, by relying on local American management who know the market and business culture. The master franchise agreement is ideally suited for this purpose.

4. As in all international franchise expansions, hire qualified professional advisors in the target country, who are experienced in international franchising and international tax planning, and who can help the franchisor achieve its goals.
OVERVIEW OF U.S. DISCLOSURE REQUIREMENTS
(UFOC FORMAT)

Item 1: The Franchisor, Its Predecessors and Affiliates. Names of the franchisor, and its predecessors and affiliates, principal business address, name and address of agent to receive process, business form, current and previous business and franchising activities, general market, competition, and industry-specific laws.

Item 2: Business Experience. Identity, position and business experience of trustees, general partners, officers, directors, others with management responsibility, subfranchisors and franchise brokers.

Item 3: Litigation. Whether the franchisor, predecessors, certain individuals and affiliates: (a) are accused in a pending action of civil or criminal franchise, antitrust, securities, fraud, unfair/deceptive practices, or comparable violations; (b) have been convicted of a felony during the preceding 10 years or have been held liable in a civil action for franchise, antitrust, securities, fraud, unfair/deceptive practices, or similar violations; or (c) are subject to an injunction or other restrictive order relating to the franchise or under an action brought by a public agency relating to the franchise under federal, state or Canadian franchise, securities, antitrust, trade regulation or trade practice law. Details include the court or agency involved, the current status of a pending action, the date of conviction or judgment, the penalty or damages imposed, and the date and terms of an order or decree.

Item 4: Bankruptcy. Details of bankruptcy proceedings involving the franchisor, affiliates, predecessors, officers or general partners during the preceding 10 years.

Item 5: Initial Franchise Fee. The initial franchise fee, including all fees and payments for goods or services to be paid to the franchisor before the franchisee’s business opens, and refund conditions.

Item 6: Other Fees. Recurring or isolated payments the franchisee must pay to the franchisor or affiliates, including royalties, training fees, advertising fees, transfer fees and renewal fees. Details include dollar amounts or percentages, due dates, computation formulas, and refund conditions, if any.

Item 7: Initial Investment. Initial investment expenditures, payees, conditions, refundability, financing terms, and other details relating to real property, equipment, inventory, deposits, licenses, prepaid expenses, and other required payments to open the franchised business and operate it for an initial phase (at least 3 months).

Item 8: Restrictions on Sources of Products and Services. Whether, and under what terms, franchisees are required to buy or lease supplies or services from the franchisor, from approved suppliers, or pursuant to the franchisor’s specifications.

Item 9: Franchisee’s Obligations. A table of principal franchisee obligations, with cross references to sections of the franchise agreement (and other agreements) and items of the offering circular.
Item 10: **Financing Arrangements.** Terms and conditions of financing arrangements offered, directly or indirectly, by the franchisor, its agent or affiliates.

Item 11: **Franchisor’s Obligations.** Details of the franchisor’s obligations prior to opening of the franchise business and obligations during operation of the business. Details include specific disclosures regarding advertising programs and cooperatives, required cash registers or computer equipment, manuals, method for selecting location, typical period between agreement and opening, and training program.

Item 12: ** Territory.** A description of any exclusive territory granted to the franchisee, and the conditions for continuing exclusivity. Concerning the franchise’s locations (with or without exclusive territory), whether another franchisee or a company-owned outlet may use the franchisor’s trademark or offer similar products or services under a different trademark.

Item 13: **Trademarks.** The principal trademarks to be licensed to the franchisee, federal and state registration status, material determinations, pending proceedings and litigation, agreements limiting use, franchisor obligations to protect franchisee rights, and known infringing uses.

Item 14: ** Patents, Copyrights, Proprietary Information.** A description of patents or copyrights owned by the franchisor that are material to the franchise, and their relationship to the franchise. General subject matter and terms and conditions for franchisee use of trade secrets claimed by the franchisor.

Item 15: **Obligation to Participate in the Actual Operation of the Franchised Business.** Whether the franchisee must participate personally in the direct operation of the business, and any required personal obligations such as a personal guaranty, confidentiality agreement, and non-competition agreement.

Item 16: **Restrictions on What the Franchisee May Sell.** Restrictions or conditions on the franchisee as to what goods or services can be sold or to whom sales may be made.

Item 17: **Renewal, Termination, Transfer and Dispute Resolution.** Table summarizing contractual provisions for termination, renewal, transfer, dispute resolution, and other important aspects of the franchise relationship.

Item 18: **Public Figures.** Any compensation to a famous person for use of the person in the franchise name or symbol or for the person’s endorsement or recommendation of the franchise.

Item 19: **Earnings Claims.** Earnings claim information is not required, but if it is included, it must include the factual basis and material assumptions demonstrating a reasonable basis for the claim.

Item 20: **List of Outlets.** Numbers of franchise outlets that were transferred, terminated, reacquired, or that ceased doing business, for each state, totaled over the franchisor’s last three fiscal years. Numbers of company-owned outlets that were opened or closed in each state over the last three fiscal years. Projected franchised or company-owned outlets to be opened in each
state during the current fiscal year. Names, addresses, and telephone numbers of present and recently terminated franchisees.

**Item 21: Financial Statements.** Audited financial statements for the last two fiscal years of the franchisor or an affiliated guarantor company and separate statements for subsidiaries. Statements must be prepared in accordance with generally accepted accounting principles. Unaudited statements may be used for interim periods.

**Item 22: Contracts.** A copy of each agreement proposed for use or in use in the state, including franchise agreements, development agreements, financing agreements, leases, options, and purchase agreements.

**Item 23: Receipt.** The required written receipt for use by the franchisee to acknowledge the franchisor’s timely delivery of the disclosure document.