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LEGAL ASPECTS OF FRANCHISING INTO AMERICA Solving the Puzzle

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LEGAL ASPECTS OF FRANCHISING INTO AMERICA – SOLVING THE PUZZLE

EXECUTIVE OVERVIEW

- Franchising in North America represents a unique combination of business opportunities and legal challenges; those include the largest and most attractive market in the world, coupled with a unique legal system.
- Risks related to the unique American legal environment are faced by all Franchisors, including U. S.-based as well as foreign, and are effectively solved by each on a daily basis.
- Proven techniques have demonstrated that legal challenges can be reasonably minimized and should not act as an insurmountable barrier to entry into the North American market, any more than they have been for successful development of U. S.-based concepts.
- A regional subfranchising strategy, as commonly used, presents both risks and advantages as compared to direct franchising or other models.
- Careful planning from a legal standpoint, as well as use of proven legal techniques, should be successful in avoidance of legal problems.

INTRODUCTION

Mature and successful franchise systems in Australia and New Zealand generally come to a point where they seriously consider expansion into North America, whether as a result of saturation of the local market, natural desire to add additional units or through receipt of inquiries from the U. S. or Canada.

For many such franchise systems, a major concern is the U. S. legal environment, with its reputation for complex regulations, out-of-control juries, multi-million dollar verdicts and a penchant for solving problems in the courtroom rather than through discussion and compromise.

While these elements of the U. S. legal system (and, to a lesser extent, that of Canada) have been exaggerated in some areas, it's not unfair to say that some of these factors do, in reality, exist, including in the franchise field and that the reality of those legal challenges must be guarded against.

What's not as well known is that:

1. U. S.-based franchise systems have dealt with this legal system for over forty years and have successfully developed techniques for reducing legal risks to an entirely acceptable level, from a business standpoint, and
2. Those pre-developed techniques have equal application to the protection of franchise systems coming to North America from abroad and should be as successful in the hands of foreign systems as they are for the vast majority of U. S.-based systems.

BUSINESS OPPORTUNITIES AND LEGAL CHALLENGES – SOLVING THE PUZZLE

North America represents perhaps the most attractive market for franchise expansion in the world, particularly for companies with mature and successful systems in Australia and New Zealand. Some of the reasons for this include the following:

- A combined Gross Domestic Product (U. S. and Canada) in excess of ten trillion US dollars (US\$10,000,000,000,000), the largest in the world, and a total population above 300,000,000, with high levels of savings, disposable income, and readiness to embrace new concepts.
- Ready acceptance of, and familiarity with, the franchise form of distribution by prospective Franchisees, retail customers, suppliers, landlords, lenders and even government agencies.
- (Nearly!) identical language, culture, legal systems and methods of doing business as compared to Australia and New Zealand, with highly educated and literate employees and professional support networks.
- A stable and low-risk political/economic environment.

At the same time, expansion into North America presents a series of unique legal challenges and questions to be answered, among them the following:

- The US legal system, even more than that of Canada, is complex and more prone to litigation than it should be. While those complexities and litigation exposure can be dealt successfully dealt with (as thousands of US franchise systems, as well as “imported” systems, do every day), in part through support of experienced U. S. legal counsel, doing business in the US legal environment is both more complex and expensive than in most other countries.
- “Common sense” and good will don’t always guarantee that the Franchisor will be insulated from potential legal exposure. Some franchise laws are inherently difficult to justify or understand (for example, providing a disclosure document to a prospective Franchisee 10 business days before the sale is appropriate, while missing the deadline by one day is illegal and exposes the Franchisor to returning all funds to the Franchisee, even without proof of any actual harm to the Franchisee.)
- A patchwork quilt of regulations exists due to the U. S. federal and state legal system (similar in some respects to Australia) and an activity entirely legal in one jurisdiction may be illegal in another.

So, what the Australia or New Zealand-based franchise system is presented with is a puzzle: How can the Franchisor access the richest market in the world for the franchise systems' products and services, while avoiding legal entanglements?

And like most puzzles, there is an answer: Use the same proven professional support, techniques and systems that have served for years to effectively protect foreign and U. S. franchise systems, some details of which are laid out below.

SYSTEMS AND TECHNIQUES FOR AVOIDING LEGAL EXPOSURE

Step 1. Experienced professional support.

Just as any journey is made easier with the support of a competent guide, the transition to North America will be greatly assisted by competent franchise counsel. What that counsel can contribute goes beyond technical legal knowledge; it should include the real-life experience of working with a series of international franchise systems and having observed their successes and challenges – experience and lessons in best practices that can be passed on to new clients, shortening their learning curve and minimizing the possibility of potential problems.

Characteristics of U. S. legal counsel should ideally include the following:

- Experience in bringing Australian or New Zealand-based concepts to the U. S. and Canada.
- In-house staff experience with one or more major international franchise systems, so as to have “seen it done right.”
- Detailed knowledge of not only federal and state franchise laws, but a personal working relationship with franchise regulators.
- Multi-year experience in working with all levels of franchise systems, allied with sensitivity to practical business concerns.
- Extensive reference list which can be verified by prospective clients.
- Wide-ranging affiliations in franchising for referrals to experienced franchising professionals.
- Membership on a senior level in state and national franchise organizations.

Step 2. Use of a North American subsidiary.

One technique used by many franchise systems entering the north American market is to organize a subsidiary, in the U. S., especially for the purpose. This can have the benefit of limiting any liabilities incurred in North America to that operation, and thereby reduce the potential exposure of the Australian or New Zealand parent corporation to liabilities incurred in the U. S.

While there are a series of factors to be examined prior to taking this step, we generally suggest that Australian and New Zealand give consideration to this precaution.

Step 3. Understanding the rules.

The federal and state/provincial rules relating to franchising, while generally more complex than those in Australia or New Zealand, are understood and effectively worked with by thousands of U. S. and Canadian-based Franchisors and their staffs on a daily basis.

What U. S./Canadian-based franchise systems can understand and work with can be equally well understood by incoming franchise executives. A commitment to being educated (see Training below) in the relevant rules, and referring complex questions to counsel, as well as to installing administrative systems to comply with the rules, should suffice.

Step 4. Training.

In franchising, as in most other business areas, details matter and a franchise system's understanding of those details, as they relate to American and Canadian franchise laws, goes a long to effectively reducing exposure.

Ideally, operational and administrative personnel should have three levels of understanding of North American franchise laws and regulations:

- A basic knowledge of the rules as they relate to the areas in which specific personnel are involved: franchise registration and disclosure rules for franchise sales/development personnel, franchise relationship regulations and anti-trust laws for operations managers, etc.
- The ability to apply this knowledge on a case-by-case basis, often using forms and procedures developed by outside counsel.
- A sensitivity to when to pick up the phone and receive the benefit of outside counsel's advice and experience, in unusual situations or where the risks of an uninformed decision might be particularly severe.

Counsel should be able to educate the senior executives, administrative staff, regional personnel and others as to applicable rules and practices and to assist in the establishment of administrative systems and appropriate procedures, as discussed below.

Step 5. Administrative systems.

One insight which we've gained over the years is that nearly all instances of legal exposure can be successfully addressed through appropriate documentation and procedures. This is particularly true in the North American context, where a knowledge of the specific legal challenges that may develop leads to appropriate administrative systems and a paper trail designed to protect against potential liability, as it does for all sophisticated North American Franchisors.

For example, if one of the challenges may be a claim that the Franchisor made promises of specific levels of financial results prior to the award of the franchise, a disclaimer signed by the prospective Franchisee that no such promises were made or relied on has been found by courts to be effective in prevailing over such a claim.

Similarly, if (as is the case) Franchisors are generally required to provide a disclosure document at a specified point in time prior to making the franchise award, a procedure (including checklists and various supporting documents) whereby a paralegal reviews the documentation prior to clearance for the award should act to make sure that all timing requirements have been met.

Step 6. Disclosure document preparation.

Key to protecting the franchise system from legal exposure is knowledgeable preparation of the franchise disclosure document (currently called the Uniform Franchise Offering Circular, or UFOC, but due to be changed in the near future.)

To be effective, that document should not be prepared merely as a set of responses to a questionnaire, but should be tailored to bear in mind the specific business dynamics of the franchise concept in question and in anticipation of the areas of exposure that may exist.

For example, a franchise concept which can only be successful where the operating franchisee has good personal sales skills should prominently note that fact in the disclosure document (and the franchise agreement) and create an expectation that success is likely to be achieved only when those sales skills are appropriately applied in the franchise business.

Step 7. Franchise Agreement provisions.

Over the years, U. S.-based franchise systems and their counsel have found that specific provisions in their franchise agreements have been highly effective in reducing or eliminating potential liability. While not wanting to turn this into a legal treatise, some of those provisions would include:

- Waiver of jury trials.
- Mandatory mediation and arbitration.
- Limitations on damages.
- Requirements that the Franchisee deliver general releases at specific points in the relationship (transfer, award of an additional franchise, renewal, etc.)
- Clarity of language in areas such as territorial rights.
- Disclaimers of earnings projections, etc.

Step 8. Exit Strategies.

Finally, it's probably fair to say that no wise businessperson enters into any new arrangement without a clearly developed exit strategy. This is no less true with franchise relationships, and a properly designed franchise system will include mechanisms for terminating the franchise relationship with minimal "drama" and potential for making the lawyers rich.

These mechanisms can include performance clauses, buy-back arrangements, requirements for transfer by the Franchisee, etc. and all such alternatives should be examined prior to completion of system design.

ALTERNATIVE STRUCTURES AND STRATEGIES

By way of background, Franchisors planning on entering the North American market should be aware of the structures most commonly used.

There are three primary structures Australian and New Zealand companies may use for franchising in North America:

Direct Franchising

In this model, the Australia or New Zealand-based Franchisor (or, as we generally recommend, a company formed for the purpose) directly awards operating unit franchises in the U. S. and Canada so that, for example, a Franchisee in Atlanta has essentially the same relationship to the Franchisor as a Franchisee in Adelaide.

This structure maximizes control by the Franchisor and minimizes certain risks, but can involve slower growth and will often require a higher level of financial commitment and allocation of management resources.

Area Franchising

Here, the structure is largely similar to the Direct Franchising model, but with the variation that area franchises are awarded (for example, for all of Dallas), with the requirement that the Area Franchisee open a specified number of units over a defined period of time. Generally, the Area Franchisee pays an area fee, above and beyond the franchise fee for each individual unit, and

receives territorial protection for the entire area, for at least the time he or she is required to meet their development obligations.

This approach can result in capital infusions to the Franchisor (in the form of area fees) and may attract more sophisticated and better financed Franchisees, as well as advancing the schedule for franchise unit roll-outs, but experience indicates that a substantial number of Area Developers fail to meet their development schedules, requiring that the Franchisor have an appropriate pre-designed exit strategy to deal with such situations.

Regional Subfranchising

This is the model most often used in international franchising, although it is not always the one we recommend.

In this approach, the Australia or New Zealand-based Franchisor does not award any unit-level operating franchises but instead only awards regional subfranchises covering large areas (all of Southern California, for example, or a single state or group of states), for which it may be paid hundreds of thousands of dollars each. The regional Subfranchisor, in turn, offers and awards, and provides nearly all after-sales service and support to the unit-level operating franchises. Initial franchise fees and royalties are split between the Franchisor and the regional Subfranchisor.

This methodology offers the possibility of rapid expansion, along with substantial fees to the Australia or New Zealand-based Franchisor, but also poses special risks. Errors in complying with complex legal requirements may haunt the development of the system and even pose risks to the Franchisor, and the universe of potential regional Subfranchisors, who can ethically, competently and effectively sell franchises and support the adequately is highly limited.

Note that this overview of alternative structures is limited (it omits, for example, a variation known as Area Representative arrangements.)

PLANNING, MARKET RESEARCH AND TEST UNITS

As noted above, solid planning and professional support will be vital to any expansion strategy. In particular, the Australia or New Zealand-based Franchisor must do the hard work of determining both the attractiveness of its concept in North America and the adaptations necessary to make retail units viable in a new environment.

Labor requirements, real estate matters, availability of supplies, government regulations, actual and potential competition and a host of other factors will enter into the changes necessary to adapt a concept and sophisticated Franchisees will want evidence that, as they say in Texas, “this dog will hunt” in a new environment.

One method of performing this adaptation, which we generally recommend, involves the setting up and operation of a model or test unit in the US. Frankly, nothing substitutes in the adaptation process for actual operation of a unit in the area in which one intends to franchise, or can be as powerful a sales tool when the time comes to award franchises.

In addition, the adaptation which results from operation of one or more test units greatly minimizes the risks of delivering a flawed franchise concept to Franchisees, and effectively reduces the potential for related liability.

Mr. Holmes is the Managing Partner of Holmes & Lofstrom, LLP, a U. S. -based law firm which is a member of the International Franchise Association, and specializes in international franchising transactions, including bringing Australian-based concepts to North America. He has been involved in the legal and business aspects of franchising for nearly 30 years and can be reached at D.Holmes@HolmesLofstrom.com or in the firm's Northern California office at 805-547-0697. Firm references and biographies are available on request.