

America offers a huge franchise-friendly market with no language barrier, but UK franchisors have been reluctant to take their systems across the Atlantic. This has largely been due to the cost of meeting America's tough franchise regulations. All that is now changing as Carl Zwisher explains.

The US lowers bar for UK entrants

THERE is a country in which franchising accounts for nearly 10 per cent of the private sector economy and nearly 50 per cent of retail sales. It indirectly employs 13.7 per cent of the private sector workforce and directly employs almost 10 million.

Yet it is a nation in which only a handful of UK franchisors are doing business. Do you know which country this is? If your answer is the U.S., you will be correct.

If you are perplexed as to why UK franchisors have not crossed the Atlantic in droves to take advantage of the opportunity, especially given the exchange rates in recent years, you are not alone. No-one knows exactly why UK franchisors have been reluctant to re-colonise North America with franchises. But if U.S. franchise laws have been the reason, that reason is about to change.

In January, the U.S. Federal Trade Commission (FTC) - which administers the country's nationwide franchise disclosure law - published new amendments which should prove welcoming to franchisors from the UK and throughout the world.

Effective from July 1 and mandatory (with respect to new disclosure standards and prohibitions) on July 1 next year, the amended rule will substantially reduce the costs of exploring the U.S. market, especially for franchisors that are not certain whether an expression of interest by an American prospective franchisee will actually lead to a consummated franchise transaction.

Perhaps you are a bit sceptical about this new "invitation" to come to America. We understand if some past experiences stateside by you British over the years have been somewhat forgettable.

We've certainly had our run-ins. Native Americans burned settlements. Then colonists refused to pay taxes, dumped tea into Boston Harbour and started shooting at anything in a red coat.

More recently, a U.S. president seduced Britain's Prime Minister into believing that invading Iraq was a good idea. Let's forget about all of this. Things have changed. Really.

Polite smiles

For years, I and other American emissaries have attended franchise conferences in the UK, extolling the benefits of bringing UK franchises to the U.S. Many of you have politely smiled, nodded and ignored us. Was it because the U.S. market is not the best in the world for franchising? Was it because of rumours of rampant litigation by unhappy franchisees? It certainly was not the language barrier, or the exchange rate.

The most likely reason is that national U.S. franchising rules, which have been in place since 1979, imposed an unreasonably high cost on the process of even talking with a prospective U.S. franchise partner. The rules of the game, however, have just changed. Under the new FTC Franchise Rule, in at least 36 states prospective franchisors can decide whether to place a bet on franchising here after they have seen their cards. The FTC's intention has been to make its 1979 Franchise Rule more relevant to contemporary franchising practices.

Although the changes are designed, with one exception, to rationalise the rule's requirements for American companies, the effect of some of the changes will lower the ante required to test the U.S. market by as much as £15,000. The rule amendments even offer exemptions for franchise investments of more than \$1 m, which means that in most American states, the FTC rule will no longer apply to many forms of franchise market testing. So exactly what has changed? The FTC has discarded the requirement that a disclosure document known as a Uniform Franchise Offering Circular (UFOC) be presented to a

prospective franchise buyer no later than the time of a first personal meeting to discuss the possible sale of a franchise.

In the past that has meant that before boarding a flight to the U.S., franchisors from the UK have needed a complete UFOC, franchise agreement and audited financial statements prepared according to U.S. accounting rules. That can easily cost £15,000 in legal and accounting fees and only gives a franchisor the chance to talk with a prospect about a deal.

If the franchisor only had one prospect, who eventually decided to pursue other options, the investment was wasted. It is not surprising, therefore, that most UK- based franchisors have not bothered to participate in the game under those rules.

Under the current rules, U.S. franchise trade show promoters do not allow a franchisor to rent a stand unless they have the appropriate documentation. The amended rule requires disclosure at least 14 days before a prospective franchisee signs a contract related to the purchase of a franchise, or at least 14 days before a prospective franchisee signs any agreements related to the acquisition of a franchise.

That means that soon a franchisor will be able to talk, and even flirt, before investing in an engagement ring. When the changes become effective, a company looking for U.S. franchise partners should be able to talk with prospects and only incur the expense of preparing a UFOC and other documents required by law if real interest in pursuing a franchise opportunity is present.

True, you will still need to prepare a UFOC before you actually collect a fee for a U.S. franchise, or sign a letter of intent. But the change remains significant.

Consider that under the amended rule, a franchisee who makes an initial investment in a franchise which exceeds \$1 m, excluding the cost of unimproved property and amounts financed by the franchisor or companies affiliated with it, is exempt from the rule. Franchisors may count amounts committed through multi-unit development agreements, or master franchise agreements in their calculations. That could mean that no UFOC and no audited financial statements would ever need to be prepared to conclude a franchise deal. That's almost like selling a franchise back in the UK.

The amended rule also has created new exemptions for the sale of a franchise to a company that has been in business for at least five years and has a net worth of at least \$5m. This provides an excellent opportunity for franchisors wishing to launch in the U.S. with a franchise partner that is already well established in business.

Another exemption exists for the sale of a franchise to an entity that is at least 50 per cent owned by an officer, owner or manager of a franchisor that has been employed by a franchisor for at least two years before purchasing a franchise. This exemption will enable representatives of a UK franchisor to set up a U.S. franchisee entity with a U.S. partner and adapt its prototype franchise to the market without incurring franchise disclosure costs.

State regulations

Before you spend the available balance on your credit card to register for the next franchise exhibition in the U.S., you should be aware that 14 states still regulate franchise sales. The FTC rule sets a floor for regulation. The states may adopt more stringent regulations, such as a requirement that all franchises be registered with a state agency before they may be offered for sale. It is too early to tell how the states will change their own laws to accommodate the amended rule.

Even if they change nothing, the other 136 states do not impose a registration requirement on franchisors, or enforce a first personal meeting disclosure requirement, provided franchisors have registered their franchise trademarks with the U.S. Patent and Trademark Office.

Franchisors which lack a U.S. trade-mark registration may be subject to "business opportunity sales laws" in many states. Although compliance with them is typically much less expensive than compliance with

state franchise laws, if a franchise is offered in a state with a business opportunity law a comparatively short disclosure is required and a filing also is usually required.

The amended rule is foreign franchisor- friendly in several other ways. First, it allows foreign franchisors to use audited financial statements prepared according to the standards of their home country, if they meet both the audit requirements of their country and the auditors prepare an explanation of the statements that makes them consistent with the accounting rules of the U.S. If they don't, the new rule permits companies that are "new to franchising", or which have not had an "audit", to meet the requirement to have three years of audited financial statements audited under U.S. audit standards over a phase-in period of three years.

The FTC has committed to issue new compliance guidelines to further explain the requirements of its amended rule. One would expect them to conclude that a company that has neither franchised in the U.S., nor has had financial statements audited under U.S. accounting standards is "new to franchising" and has not previously had an "audit."

Other new changes include:-

- UFOCs may be delivered electronically. Paper disclosure documents are no longer required.
- If a franchisor and prospective franchisee negotiate changes in a franchisor's standard-form agreements at the request of the prospective franchisee, the parties no longer need to wait five business days to sign the agreements.
- If a UK franchisor must prepare a UFOC, it will be able to conduct market research with its prospective franchisee's input before placing its estimates of the franchisee's initial investment in the UFOC. The estimates have always been required, but so long as the first personal meeting requirement remained, the only way for a foreign franchisor to make realistic estimates was through potentially expensive market research, which added to the cost of preparing the UFOC.

The UFOC still contains a requirement to disclose information in 22 different items. All standard-form agreements that a franchisee would be expected to sign must be included in the UFOC package, along with a list of current franchisees and a list of franchisees that have left the franchise network during the franchisor's previous fiscal year. Three years of audited financial statements of the franchisor must also be included.

The amended rule adds some disclosures to those previously required and deletes others. By and large, any franchisor who has reviewed the requirements in the past is likely to be favourably impressed with the changes.

Conclusions and recommendations

The amendments to the Franchise Rule will make initial legal compliance cost associated with testing the U.S. franchising market much lower. Notwithstanding the changes, if you are a UK franchisor, you should study differences between the U.S. and UK markets, register your company's trademarks in the U.S. and prepare a prototype of the franchise agreement(s) you expect to grant before seriously looking for an American franchise partner.

As a franchisor, you should be able to answer the questions which are likely to be presented by a bona fide prospective franchisee. One way to prepare for those questions is to review the information required by the UFOC and to develop, as a minimum, tentative answers to UFOC questions.

Because of the time required for their preparation, UK franchisors should not wait to start drafting documents for execution by a prospective franchisee until after they have reached agreement on deal points. A letter of intent only may be signed after disclosures have been made.

Before signing a letter of intent, a UK franchisor should be satisfied that it understands the differences between the U.S. and the UK markets and how those differences will impact on deal terms.

If you are advising a UK franchisor and you are negotiating a master franchise, you should factor into your cashflow calculations that U.S. based master franchisees will usually be required to comply with the Franchise Rule and applicable state laws, and that the time required for them to prepare the documents and obtain necessary registrations or exemptions will extend the time between their signing master franchise agreements and the date when they may begin offering franchises.

That said, welcome to America.

Franchiseworld May 2007