Barriers, Foreseen and Unforeseen, Face Franchisors Entering the U.S.

U.S. disclosure requirements may very well be the most complex of any country.

BY BEATA KRAKUS

There are certain challenges to any franchise system going into a new country, regardless of the franchisor's home nation and where the country is taking its brand. "Going international" means adapting the brand to another country's language and culture, and, of course, complying with that country's laws. But what if the United States is the foreign country a franchisor is entering? How do non-U.S. franchisors see us? Is the United States truly the land of the free or are we putting up barriers to entry that may deter foreign franchisors?

Litigious Society and Product Liability a.k.a. "the McDonald's Coffee Case"

Almost universally, independent of the foreign company's size or home country, when entering the U.S. market for the first time, concerns are voiced about being sued in the United States and about product liability. Whether those concerns are rational or not, they are in themselves significant barriers to entry.

It is hard to contradict that the United States is a litigious society. Assurances from U.S. counsel that almost every case settles or is dismissed before trial go only so far in appeasing foreign clients. Likewise, product liability is a major concern for foreign businesses. The McDonald's coffee case is widely heralded as the epitome of U.S. product liability laws. That case, coupled with U.S. warning labels cautioning not to put your baby in the microwave oven and similar commonsensical warnings, causes significant angst among foreign businesses. In reality, with one big exception, U.S. and foreign product liability laws are often similar. For example, the European Union used U.S. strict product liability laws as a model when preparing the EU directive on the same topic. There is one big difference, and much of the fear lies in that: the amount of damages awarded. While there may be good socio-political reasons to explain why U.S. damages are higher, news stories about multi-million dollar awards traverse the globe quickly and don't pick up the nuances.

Complex Franchise Laws

The barriers described above are common to all foreign businesses, but franchising in the United States presents its very own additional issues for foreign franchisors. While U.S. laws don't have nightmarish limitations on foreign business ownership or on the ability to expatriate profits, franchisors coming here certainly do not find a market free of regulation and restrictions. Many foreign franchisors are frustrated that there are both federal and state franchise regulations. They are also surprised by the scope of required franchise disclosures. U.S. disclosure requirements may very well be the most complex of any country and as such give many foreign franchisors pause.

FDD Accounting Standards

Though our franchise regulation applies to all franchisors, for foreign franchisors, the financial statement requirements can take on a different meaning. Under the Federal Trade Commission Franchise Rule and various state franchise laws, generally the franchisor is required to include its audited financial statements in its franchise disclosure document. If the franchisor's parent guarantees the franchisor's obligations to the franchisees, or if the parent performs post-sales obligations of the franchisor, the parent's financials must also be included. These rules apply to all franchisors, but for foreign franchisors they may present unique challenges that can be costly to overcome.

For U.S. franchisors, determining which accounting standard to use is never an issue. They simply use their audited U.S. Generally Accepted Accounting Principle financials. Foreign franchisors, however, usually do not have U.S. GAAP financials, but use some version of the International Financial Reporting Standards or their own country's generally accepted accounting principles.

Frequently the issue of accounting standards is overcome by the foreign franchisor setting up a U.S. entity to act as the U.S. franchisor. That entity's financials are prepared in accordance with U.S. GAAP. But not all franchisors wish to set up a U.S. entity and sometimes the financials of the foreign parent must also be part of the FDD.

If the franchisor does not wish to have a U.S. entity, or if it is required to include parent financials, the accounting standards issue is put to the test.

Under the FTC Franchise Rule, U.S. GAAP is not necessarily the only permissible accounting standard. The FTC also permits other accounting standards as permitted by the U.S. Securities and Exchange Commission. "As permitted by the SEC" currently means U.S. GAAP or for "foreign private issuers" it means you can instead use the English language version of IFRS, or the local home-country generally accepted accounting principles. If the home-country GAAP are used, the financials must be reconciled with U.S. GAAP. Reconciliation is not a requirement for IFRS financials. To simplify, a "foreign private issuer" is a company with majority ownership and management by non-U.S. residents, and one that files reports with the SEC.

It is unclear from the wording of the FTC Franchise Rule if it is intended to permit all franchisors to use these other accounting standards permitted by the SEC, or if the FTC intended to limit the right to foreign private issuers, like the SEC does. The SEC's guidance is only with respect to entities that are subject to securities filings. There is currently no guidance from the FTC as to whether the SEC permission to use IFRS should be expanded to all foreign franchisors (or to all franchisors, for that sake) or should be limited only to those that are "foreign private issuers."

Without such guidance, the foreign franchisor is then left with the option to spend significant funds on restating its financials in accordance with U.S. GAAP, or setting up and capitalizing a separate entity that can have its financials audited in accordance with U.S. accounting standards.

Yet even if a franchisor were able to get sufficient guidance from the FTC that it can use IFRS financials or other reconciled foreign financials to comply with the FTC Franchise Rule, it will still be forced to face state franchise examiners. Several state franchise laws are interpreted by examiners as requiring the use of U.S. GAAP financials. Thus, for a foreign franchisor that wishes to franchise throughout the United States, having U.S. GAAP financials will be a requirement for the foreseeable future.

Aside from the legal issues that are inherent in the U.S. legal system and face all foreign businesses entering the U.S. market, foreign franchisors have additional barriers to entry in the accounting standards under the FTC Franchise Rule and state franchise laws. Sometimes the accounting standards issue can be overcome by setting up a U.S. entity, but that is not always the case. Where a franchisor does not wish to set up a U.S. entity or is required to include parent financials in its FDD the cost and time expended in preparing U.S. GAAP financials can be considerable. Luckily, with so many lawyers in the United States, foreign franchisors should, at least, have no difficulty finding legal counsel to guide them through our sometimes thorny legal system. ■

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