



International Distribution Institute

**Case Study:
Distribution vs. franchising:
pros and cons when retail goes international
from a legal perspective**

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Role of Legal Requirements on Market Entry

Legal requirements may impact significantly a retailer's decision to enter into a specific foreign market.

Sometimes, statutory laws may not only influence but even supersede other strategic aspects such as brand control, finance, and supply chain.

This case study will try to highlight the considerations and obstacles a retail distribution system might face when considering entry into foreign markets with statutory regulations on expansion models such as franchising.



Hypothetical – Excream’s Entry Into US Market:

Fashion retail brand “Excream”, based in the EU, is considering entry into the US market. Excream sells fashion in monobrand or to departments stores.

Monobrand stores are either company owned or franchised to single- or multi-unit operator.

Within Europe Excream uses master franchise agreements to enter into other European markets.

When selling products to department stores, it uses distribution agreements paralleled by trademark license.



Excream's Entry into US Market

In some markets, Excream also operates with franchise-like “distribution agreements,” if it is easier to do so for market entry or legal compliance reasons.

In those cases, it charges an **advertising pool fee** to be able to promote the product through brand advertising and has a **higher mark-up on the merchandise** its sells its distributors to compensate for its loss of royalty fees it would otherwise get from its franchised stores.



Excream's Entry into US Market

Two Questions:

1. Can Excream legally use a “franchise-like” distribution arrangement with its fees without complying with the franchise laws if it franchises in the United States?
2. Alternatively, if Excream Franchises, is the master franchise approach the best approach in the United States from a legal perspective?



1. Specific franchise laws

Federal

- FTC Franchise Rule – disclosure
- No General Relationship Law

State

- Franchise Sales Laws – disclosure and filing/registration
- Business Opportunity Laws – disclosure and filing/registration
- Relationship Laws – govern various aspects of franchisor/franchisee relationship/contract



a. disclosure laws – general comments

Franchising in the U.S. is regulated under federal law and, in some cases, state law.

Unless a transaction is excluded or exempt, pre-sale disclosure is mandatory.

Typical European disclosure documents do not meet the requirements and must be adapted or newly prepared.

It is time consuming and costly from a European perspective.



Salient issues include:

aa. financial statements

The franchisor's audited financial statements for the past three fiscal years must be included. The FTC Rule requires that the financial statements be prepared according to U.S. generally accepted accounting principles (GAAP).

The financial statements must be audited by an independent certified public accountant (CPA) using GAAP.

Non-U.S. franchisors that do not form a U.S. affiliate to conduct the franchise program may face the issue of whether or not their CPA and audited financial statements meet these standards.

Possible to prepare reconciliation between the standards under which the franchisor's financial statements were audited and GAAP, but this can cause delays if the franchisor has not already considered this issue early in the planning process.



bb. Financial Performance Representations (FPRs)

It is often desirable to provide this type of information to prospective franchisees because it allows the franchisor and its representatives to discuss the substance of the representation with prospective franchisees.

The FTC Rule and state law require that a franchisor have a reasonable basis and written substantiation for any financial performance representation it makes. An issue can arise for a non-U.S. franchisor because when it enters the U.S. market it does not have franchisees in the United States and, therefore, cannot base its financial performance representation upon U.S. franchisees' historical results. If the franchisor is a newly-formed U.S. entity, it will not yet have any financial results based on its own company operations. Does a non-U.S. franchisor have a reasonable basis for presenting non-U.S. financial performance information to U.S. prospective franchisees?



cc. State laws

Fifteen states also regulate the offer and sale of franchises. Fourteen of the fifteen states with franchise laws that address the offer and sale of franchises also require the registration of franchise offers.



dd. Exclusion from the FTC's Franchise Rule and State Law include:

Exclusion of Distribution Agreement from Franchise Sales Laws??

Excream could avoid application of Franchise Sales Laws if it is not a "franchise"

Definition of a Franchise

FTC Rule

State Law

For Excream, is there a "Franchise Fee"?



ee. Exemptions from the FTC's Franchise Rule and State Law include:

Exemption of Distribution Agreement from Franchise Sales Laws

Excream could avoid application of Franchise Sales Laws if qualifies for an exemption under Federal and State Law

Minimum Payment Exemption;

Fractional Franchise Exemption;

Large Franchise Investment Exemption;

Large Franchisee Exemption;

Insider Transaction Exemption;

General Partnership Exemption;

Single Trademark License Exemption (see Benetton);



b. relationship laws

A number of states and territories also regulate the relationship between franchisors and franchisees. Franchise relationship laws occasionally regulate the right of a franchisee to associate with other franchisees, the location and governing law for dispute resolution, and competition by the franchisor. Several states also prohibit a franchisor from discriminating among franchisees.

c. business opportunity laws

More than 20 states also have laws that address the offer and sale of business opportunities. These laws frequently exempt franchises from their coverage.



2. Anti-terrorism laws

Non-U.S. franchisors entering the U.S. market must investigate and comply with anti-terrorism and similar laws, especially if they form a U.S. entity to conduct business in the United States.

The United States Treasury Department implements various laws and measures for the purpose of enhancing national security through economic sanctions, addressing financial networks of terrorist organizations and safeguarding domestic financial institutions.



3. Import of goods

Any goods or materials exported to the United States will be subject to formal U.S. Customs entry procedures, including duty assessment. A key decision for foreign franchisors is the choice of person or entity to act as "U.S. importer of record" in connection with imports into the U.S. The importer of record is the party responsible to U.S. Customs for the payment of duties and compliance with all import restrictions and formalities. The foreign franchisor can do one of the following:

1. (i) establish a U.S. subsidiary for this purpose;
2. (ii) rely on an unrelated third party (such as its U.S. developer);
or
3. (iii) act as a foreign importer of record itself, although this last alternative is not generally recommended.



4. Immigration

Admission of foreign persons into the United States is governed by the U.S. immigration laws.



5. Tax program

Non-U.S. franchisors should have their local and U.S. tax and corporate advisors consult together on the choice of an entity to conduct franchise operations in the United States.



Thank you

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