How New York Can Be a Center for International Franchising

By Thomas M. Pitegoff

New York prides itself on being an international hub of trade, finance, culture and diplomacy. Lawyers know that New York is also an important venue for the resolution of international disputes. Since 1984, New York has specifically promoted designating New York law as the governing law in international contracts and New York courts as the forum for the resolution of international disputes.[1] The New York State Bar Association endorsed the choice of New York law and forum in its 2011 Task Force report on New York Law in International Matters.[2]

By contrast, New York's franchise law discourages international franchising in New York. In both outbound and inbound international franchising, the New York Franchise Sales Act (NYFSA)[3] impedes international business in the state.

The NYFSA was enacted in 1981 and has never been amended. But with just two changes in the law, New York can break through this impediment and become a magnet for international franchising.

- Outbound transactions: Make it clear that the NYFSA does not apply when a franchisor in New York enters into one or more agreements granting to franchise buyers abroad the right to own and operate franchises to be located exclusively outside of the United States.
- Inbound transactions: Allow a franchisor outside the United States to grant master franchise rights in the U.S. to a single New York business to sell franchises without requiring the franchisor outside the United States to prepare detailed franchise disclosures or to register the single franchise offering to a U.S. master franchisee.

Under current New York law, both outbound and inbound international franchise sales require compliance with extensive registration and disclosure requirements.

These changes in New York law need not strip the Department of Law, also known as the Attorney General's Office, from jurisdiction over outbound and inbound international transactions through the anti-fraud provisions under the NYFSA.[4]

Just to clarify, in an inbound transaction where a foreign franchisor grants master franchise rights to a single New York person, the foreign franchisor would not be required to prepare a detailed franchise disclosure document and register as a franchisor with the New York Attorney General's Office. However, the New York master franchisee would be required to comply with the U.S. federal and state registration and disclosure requirements, which may include disclosures about the foreign franchisor.

A change in the NYFSA to relieve the foreign franchisor from the obligation of preparing an FDD and registering the offering for the single agreement would go a long way toward facilitating international franchising in New York. It would allow the foreign franchisor and the New York franchisee to move quickly to negotiate and sign the master franchise agreement.

Franchise Law Background

The sale of franchises in the U.S. is regulated by federal and state laws. The Federal Trade Commission (FTC), through its trade regulation rule on franchising (FTC Rule),[5] requires franchisors throughout the U.S. to make detailed written disclosures to each franchise buyer before the buyer signs the franchise agreement or makes any payment to the franchisor. These disclosures must be in the prescribed format called a "franchise disclosure document" or FDD.

New York also requires franchisors to prepare an FDD and deliver it to franchise buyers before they purchase the franchise. New York and several other states[6] also require franchisors to register their franchise offerings before they can sell franchises in the state. In New York, franchisors register their franchise offerings with the Attorney General's Office.

Preparation of the FDD is a detailed and time-consuming process. Among other things, the FDD must include the franchisor's audited financial statements. Franchise registration in New York entails the Department of Law's review of the FDD for compliance and possible revisions. This review process commonly takes weeks to complete, following weeks spent preparing the FDD.

Selling Franchises Abroad

The NYFSA appears to apply to a New York franchisor's franchise sales abroad, unlike the FTC Rule and unlike any other state franchise sales law. Whether a New York franchisor is granting a franchise for a single unit in Canada or development rights for the entire European Union or all of China, the franchise offering must be registered in New York.

Thomas M. Pitegoff is a member of the Executive Committee of the NYSBA's Business Law Section. He is an attorney with the law firm of Offit Kurman, P.A.

Following its text, the NYFSA applies when a person offers to sell or sells a franchise in New York.[7] A person offers to sell or sells a franchise in New York when

> an offer to sell is made in this state, or an offer to buy is accepted in this state, or if the franchisee is domiciled in this state, the franchised business is or will be operated in this state.

An offer to sell is made in New York

> when the offer either originated from this state or is directed by the offeror to this state and is received at the place to which it is directed. An offer to sell is accepted in this state when acceptance is communicated to the offeror from this state.[8]

There appears to be no limit on the international application of the NYFSA. As long as the offer originates from New York or the acceptance is communicated from New York, the law may apply, even if the franchisee is located abroad.

> "A change in the NYFSA to relieve the foreign franchisor from the obligation of preparing an FDD and registering the offering for the single agreement would go a long way toward facilitating international franchising in New York."

The courts have long upheld the constitutionality of the extraterritorial reach of the NYFSA. At least one court has held that the broad extraterritorial reach of the NYFSA does not impose an impermissible burden on interstate commerce. [9]

No other state requires a U.S. franchisor to register in order to sell franchises to out-of-state residents for franchises to be located outside the state, let alone anywhere outside the U.S. [10]

Federal law also does not regulate the sale of franchises abroad. The FTC Rule refers to the offer or sale of a franchise "to be located in the United States of America or its territories."[11] Foreign franchise purchasers are likely to be sophisticated companies represented by counsel. Countries differ in markets, cultures and legal systems. Because offerings in different countries are likely to differ, the FTC noted in its Statement of Basis and Purpose[12] that, if the FTC Rule were to apply to franchises located outside the U.S.,

> a franchisor arguably would have to prepare individual disclosure documents tailored to each specific foreign market. Not only would such a requirement put American franchisors at a competitive disadvantage with franchisors from countries lacking comparable disclosure regulations, but it is likely that any possible benefits of such a requirement would not outweigh the extraordinary costs and burdens involved.

Inbound Franchising

Inbound franchising from a foreign franchisor to a U.S. master franchisee in New York is also problematic. Appointing a master franchisee in New York clearly requires registration and disclosure under the NYFSA unless an exemption applies. A company outside the U.S. that wants to grant master franchise rights to a single master franchisee located in New York must register that offering with the state and must provide the required disclosures to the single prospective master franchisee.

The NYFSA does exempt the sale of a single franchise.[13] But this exemption only applies if the franchisor does not grant the franchisee the right to offer subfranchises to others. Because a master franchise necessarily includes the right to grant subfranchises, this single-sale exemption does not apply to the grant of master franchise rights.

Master franchising is a common approach to international franchising. In international master franchising, the franchisor in one country grants to a company in the destination country the right to sell franchises and to manage the franchise system in the destination country. Master franchising in the U.S. is most commonly used in outbound franchising into other countries.

Master franchising is less common in inbound international franchising. One reason for this is that the foreign franchisor may need to prepare a disclosure document and register before granting the single master franchise agreement, whether in New York or in another state that requires franchise registration. At the federal level, on the other hand, the grant of a single master franchise for the entire U.S. may arguably fall within the scope of the single trademark license exclusion under the FTC Rule. [14]

A second reason that master franchising into the U.S. is not common is that both the U.S. master franchisee and the foreign franchisor would be required to disclose to the master franchisee's buyers in the U.S. in one FDD, with each being responsible for the other's compliance with the disclosure requirements.[15] The FDD would need to include the audited financials of both the foreign franchi-

sor and the U.S. master franchisee. This is especially difficult when the master franchisor is not a U.S. company.

For this reason, it often makes sense for a foreign franchise company to form a subsidiary in the U.S. to sell franchises, whether that subsidiary is wholly owned or a joint venture with a U.S. partner. But some companies are not ready to set up their own operation in the U.S. And in some cases, such as franchising from Canada, direct unit franchise agreements into the U.S. might be the best approach, with the foreign franchisor fully complying with U.S. registration and disclosure requirements. The foreign franchisor might even set up a wholly owned company in New York to be the franchisor while managing the operation from its offices abroad, with an entirely offshore set of officers and directors.

Discretionary Exemption in N.Y.

The NYFSA does offer a way to escape its own impediments to international franchising. New York allows franchisors to seek a "discretionary exemption" from the registration and disclosure requirements. The Department of Law may grant a discretionary exemption "if the department finds that such action is not inconsistent with the public interest or the protection of prospective franchisees."[16]

Requests for discretionary exemption are made by letter addressed to the New York Department of Law explaining the facts and the basis for the request. The applicant's attorney must also file a Notice of Appearance and pay a small fee. The current assistant attorney general in charge of franchising in the Investor Protection Bureau has said that he commonly grants discretionary exemptions for the sale of franchises outside the U.S. But relying on the policy of a particular assistant attorney general is not the ideal way to handle this issue. We have no way of knowing whether his successor will be so generous in granting discretionary exemptions for international franchise sales. It would be far better to change the law to make it clear that there is no need for this burdensome requirement in New York.

Change New York Law

One approach to correcting both the outbound and inbound international impediments to franchising in New York law and promoting New York as a base for international franchising would be to add a new Section 684.7 to the N.Y. General Obligations Law which might read as follows:

> The offer or sale of a franchise shall be exempted from the registration and disclosure requirements of Section 683 of this Article if:
>
> (a) The offer or sale is directed to any number of persons for the right to operate one or more franchises to be located outside of the United States; or
>
> (b) The franchisor is domiciled outside of the United States and the franchisor grants to a single person in this state the right to own and operate one or more franchises and to grant subfranchises.

A better way to handle the outbound franchise sales issue would be take the approach of every other state that requires franchise registration by exempting franchise sales where the buyer is a resident of another state or country.[17] In other words, any franchise sale outside of New York would be exempt, whether the franchise buyer is located in another U.S. state or abroad.

The law might also go one step further and provide that the offer to the out-of-state buyer must not violate federal law or the law of the foreign jurisdiction where the franchise business will operate or where the franchisee is domiciled.[18] In addition, this change in New York law need not relieve the New York franchisor of the requirement to comply with the anti-fraud provisions of the NYFSA.[19]

A number of other changes in the NYFSA would make New York even more appealing as a center for franchising generally.[20] The most important of these changes would be to revise the overly-broad definition of a franchise under the NYFSA to conform to the definition of a franchise used in other states. Another important change would be to revise the waiting period between disclosure and contract signing, requiring 14 calendar days instead of 10 business days and eliminating the requirement to deliver the FDD at the "first personal meeting" with the prospective franchisee.

These changes are important. They would bring New York franchise law more into line with the franchise laws of other states and encourage more franchise companies to set up their operations in New York. A new exemption for inbound international franchise transactions in particular, would set New York apart from other states that require franchise registration and might attract more franchisors abroad to launch their U.S. franchise operations from New York.

Endnotes

1. N.Y. General Obligations Law (GOL) Title 14, Sections 5-1401-5-1402.
2. Task Force on New York Law in International Matters, https://nysba.org/NYSBA/Sections/Dispute%20Resolution/Dispute%20Resolution%20PDFs/Task%20Force%20on%20New%20York%20Law%20in%20International%20Matters.pdf.
3. N.Y. General Business Law (GBL) Article 33, Sections 680-695.
4. N.Y. Gen. Bus Law § 687.
5. 16 CFR Part 436.

6. These states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, North Dakota, Rhode Island, South Dakota, Virginia, Washington, Wisconsin.

7. N.Y. Gen. Bus. Law § 683(1).

8. N.Y. Gen. Bus. Law §§ 681(12)(a) and (b). *See A Love of Food I v. Maoz Vegetarian USA, Inc.*, Bus. Franchise Guide (CCH) ¶14,684 (D. Md. 2011).

9. *Mon-Shore Management, Inc. v. Family Media, Inc.*, 584 F.Supp. 186 (SDNY 1984).

10. For example, the California Franchise Investment Law provides as follows in Cal. Corp. Code § 31105:"Any offer, sale, or other transfer of a franchise, or any interest in a franchise, to a resident of another state or any territory or foreign country, shall be exempted from the provisions of Chapter 2 (commencing with Section 31110) of this part [the registration and disclosure requirements], if all locations from which sales, leases or other transactions between the franchised business and its customers are made, or goods or services are distributed, are physically located outside this state."

11. 16 C.F.R §436.2.

12. Statement of Basis and Purpose, 72 Fed. Reg. 15,445 (Mar. 30, 2007) at page 15,468 (text accompanying footnote 248.)

13. NY GBL §684(3)(c).

14. The FTC Rule excludes the grant of the right to use a trademark where the license is the only one of its general nature and type to be granted by the licensor with respect to the trademark. This exclusion is one of four non-franchise relationships that appeared as specific exclusions in the 1970 franchise rule at 16 CFR 436.2(a)(4)(i)-(iv). These exclusions are retained in the revised FTC Rule as a matter of policy, although the specific text of the exclusions was removed from the final Rule as part of the FTC's effort to streamline the Rule. See notes 67, 777 and 871 of the Statement of Basis and Purpose and the accompanying text. 72 Fed. Reg. 15,544 (March 30, 2007).

15. See the FTC's Franchise Rule Compliance Guide, p. 17 (May 2008).

16. N.Y. Gen. Bus. Law § 684(1).

17. *See supra* note 6. *See also* Exemptions and Exclusions Under Federal and State Franchise Registration and Disclosure Laws, American Bar Association, 2017.

18. As in the franchise laws of Rhode Island, South Dakota and Wisconsin. In Rhode Island, an offer or sale of a franchise is exempt if

    > (1) It is offered or sold to a nonresident of this state; (2) the franchise business will not be operated wholly or partly in this state; (3) the offer or sale does not violate federal law or the law of the foreign jurisdiction; and (4) the offeree is not actually present in this state during any offer or sale. R.I. Gen. Laws § 19-28.1-7.

    In South Dakota, an offer or sale of a franchise is exempt if

    > the offer or sale is made to a person not a resident of this state, if the franchise will not be located in this state, and if the offer or sale does not constitute a violation of the laws of the state or foreign jurisdiction in which the offeree or purchaser is present and is not part of an unlawful attempt to evade this chapter. S.D. Codified Laws § 37-5B-3.

    In Wisconsin, an offer or sale of a franchise is exempt

    > where the franchisee or prospective franchisee is not domiciled in this state and where the franchise business will not be operated in this state, and provided that the offer, sale and purchase of the franchise is effected in compliance with any applicable franchise law of the state in which the franchise business will be operated or the franchisee is domiciled. Wis. Admin. Code DFI § 32.05(1)(d).

19. *See supra* note 4.

20. See Thomas M. Pitegoff, *Franchising in New York After the Revised FTC Rule*, N.Y. Business Law Journal, Fall 2007, Vol. 11, No. 2. The NYSBA's Business Law Section proposed sweeping changes to the NYFSA in a report dated November 10, 2009. The Executive Committee of the NYSBA endorsed these changes in January 2010. But these changes have not been enacted into law.