Watch Your Step in Crossing the U.S. Border

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According to the Government of Canada, "Canada and the United States enjoy the longest, deepest, most peaceful, and mutually beneficial relationship between any two countries in the world. No two nations depend more on each other for their mutual prosperity and security than the US and Canada."[1] In 2016, bi-lateral trade between Canada and the U.S. exceeded CAD$841 billion.

Typically, Canadian franchise systems looking to expand internationally consider the United States as a primary potential candidate for such expansion. The reasons for considering the United States as a next step in the expansion process include its proximity to Canada, the similarity of culture (at a macro level), the established trade relationship between the countries, and the existing business networks on both sides of the border. Having said that, there are potential disadvantages to consider, including the exchange rate differential, increased competition, and the evolving political environment (particularly with regard to transnational trade). Achieving success in the U.S. requires careful planning and deployment of resources (as with expansion to any jurisdiction), but it also involves understanding the nuances of a nation that, despite its closeness in proximity and culture, is not so similar. So what analysis should franchise systems undertake, and what considerations should franchisors address, in exploring expansion from Canada to the United States?

Do due diligence. One preliminary and critical consideration is whether the concept requires adaptation for the U.S. Stereotypically, adaptation is considered important for jurisdictions with vastly different cultures. However, it should not be assumed that a successful business concept in Canada will automatically succeed in the "much larger" U.S. The United States has distinct regions with equally distinct predilections. Accordingly, broad feasibility analysis, whether informal (such as franchisor-led research) or formal (e.g. commissioned feasibility studies) should be a first step. Such analysis will also cover matters such as import/export requirements, supply chain requirements, and competitiveness in particular regions. The legal aspects of that analysis will include matters such as product and service compliance, business licences and permits, and franchise-specific laws (discussed further below). Finally, careful thought must be given to the resources (including human capital) required to launch the expansion initiative.

Protect IP. For any franchise system looking to expand into the U.S., trademark clearance and registration is particularly crucial, and should be considered early in strategic planning. Importantly, as is the case in Canada, trademark rights can exist at common law in the U.S. (i.e. without registration). Given the size of the U.S., it is precarious to march in without proper searching and investigation. Nothing is more disruptive to development than responding to a claim of infringement or the realization that rebranding may be necessary because of an unexpected U.S. cultural issue. Unfortunately, there are many examples of such scenarios. A recent example (in the authors' experience) is a franchise system that was required to undergo rebranding of the entire franchise system because it discovered on expansion into the southern U.S. that its primary trademark was a derogatory term to certain ethnic groups that lived in this area. The intellectual property of franchise systems extends beyond trademarks, and often includes trade secrets and copyright. Ensuring that all pertinent intellectual property can be protected in the U.S., and understanding best practices with respect to policing the same, is quintessential. Accordingly, with respect to the examples provided above, copyright protection is enhanced through national registration in the U.S., and carefully drafted (and monitored) nondisclosure covenants can protect proprietary methods and marketing secrets.

Structure advantageously. An often overlooked "structuring" decision is the corporate/tax structuring that should be done prior to identifying a counterparty and selecting the appropriate franchise "structure" (i.e. master franchise, area development, area representation, etc.). This, for the most part, involves selecting the most appropriate entities on each side of the border that will work to the strategic plan of the franchisor and other stakeholders (particularly with respect to the flow of funds). A robust corporate/tax structuring analysis should be undertaken with accounting and legal professionals on both sides of the border. Identifying the right structure based on the strategic plan and requirements of the franchisor is key to effective tax planning, and also to providing the franchisor freedom to achieve its current and future expansion objectives (including into other foreign jurisdictions).

Select partners and arrangements carefully. Finding the right partner for the U.S. and structuring the right kind of arrange-

[1] [http://can-am.gc.ca/relations/commercial_relations_commerciales.aspx?lang=eng]

ment is critical for both parties, as it is usually a long-term relationship. Moreover, certain states regulate how franchisees may be terminated, and the substantial investment made by a franchisee will often make courts reluctant to enforce a termination of the franchise agreement. All that to say, conducting due diligence on potential partners (particularly those who have reached out to the franchisor) is not only prudent, but necessary. Nothing is more disruptive to expansion plans than to discover that the chosen master franchisee cannot effectively promote or sell the franchise system, or that the developer lacks operational experience or sufficient funding to develop according to the agreed timetable. Another point to bear in mind when considering master franchisees is that they themselves must disclose their litigation and bankruptcy history (together with certain violation of laws by key individuals) as part of the franchise disclosure to prospective franchisees. Ideally, franchisors should work from a strategic plan that includes the “end game” as it relates to carving up territories and regions in the U.S., as well as the different kind of arrangements that are contemplated. Notwithstanding that the plan may change, it is better to start with a well-thought-out strategy.

Craft robust contract terms. The business terms of the deal should be reflected and enhanced by the legal terms of the arrangement, and both must take into account the nuances of U.S. laws. Default and termination provisions provide a poignant example. Terminating counterparties in the U.S. can be a challenge. A number of states have laws that restrict termination of franchise agreements. Often these laws prevent termination without “cause,” and contain mandated rights to cure and advance notice requirements. Carefully drafted contracts defining “cause” and describing the parties’ agreements regarding the right to cure and notice periods can greatly assist in protecting a franchisor expanding to the U.S. There are also particular drafting approaches with respect to arbitration provisions and the manner in which parties limit the scope and procedures of the arbitration. These agreements will generally be enforced. Other mechanisms may also be used (subject to various state laws) to protect the franchisor, e.g. loss of exclusivity for underperforming franchisees.

Watch out for immigration and employment requirements. Exploring a potential expansion often involves spending time in the relevant city or region in the U.S. Fronting up to the border unprepared and unable to appropriately explain the purpose of your visit can result in a denial of entry to the U.S. It can be as inadvertent as saying the wrong word. Work permits are not always required during this preparatory/exploration stage, but as stated above, if the purpose of your visit is mischaracterized, it can trigger such a requirement. Once several franchisees are in place, training and field visits may become necessary. At that point, it is more likely that franchisor staff entering the U.S. will require a work permit. Having said that, work-arounds may be available in certain circumstances. As many are aware, employment laws in the U.S. are different, but employment-related matters such as joint-employer classification also require careful and separate consideration. Franchisors looking to cross the border should obtain specific legal advice on these matters, together with the proposed organization structure and the intentions with respect to sending employees across the border (or otherwise employing staff in the U.S.).

Understand franchise regulation. Franchise regulation occurs both at the state and federal level in the U.S. Franchisors must comply with both federal and the applicable state laws, which vary from state to state. Nationally, the disclosure-based requirements are mandated in a prescribed form. At the state level, in addition to disclosure requirements, some states require advance registration of the franchise before offering a franchise for sale. These states may impose additional requirements as a condition to granting the right to sell franchises in their jurisdiction. Failure to comply with all applicable laws may lead to expensive regulatory enforcement actions or litigation against the franchisor and its officers or owners by affected franchisees. Franchisors expanding to the U.S. should also be aware that state regulators communicate with each other, and violations in one state may trigger regulatory investigations in other states. In a similar way, lawyers who specialize in representing franchisees often represent franchisees in many states, and it is not uncommon for those lawyers to bring claims on behalf of multiple franchisees within the same system across many states (once a violation by the franchisor is detected in a particular state).

Finally, there are (as with any jurisdiction) specific regulatory and trending issues that a franchisor ought to be aware of, as well as best practices developed in the U.S. for addressing such matters. Recent federal regulatory actions in the U.S. have attempted to hold franchisors responsible as a joint employer of franchisees and franchisee employees. The advent of the new political administration may result in additional changes to these efforts, but careful structuring of franchise agreements, system standards, and operational requirements can limit exposure for these potential liabilities, even under the stricter regulatory scheme. Cybersecurity is another trending global issue, and obligations in this area are on the rise in the U.S. In addition, depending on the industry in which the franchise system operates, there are often other regulatory obligations to comply with (e.g. product labelling, governmental licensing and permits, etc.). In light of the above, it is critical for franchise systems looking to cross the border to carefully consider their expansion into the U.S., to undertake the appropriate investigatory work, and to obtain pertinent advice, so that they are best placed to achieve success in the U.S.

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