

Practice Update

Is Your Franchise Ready for the U.S. Market?

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Non-U.S. franchisors often look to the United States as the holy grail for franchising, with its multicultural states with large consumer population centers. But the U.S. marketplace presents a challenge to the unfamiliar, and entry is difficult, because while the United States is one nation that regulates franchising at the federal level, its 50 states offer up distinctly different marketplace realities, with distinctly different state franchise laws and regulations. It also has a variety of available forms of intellectual property to protect the franchise brand and concept.

Franchise Models in the U.S. The first issue to address is what franchise model (or models) the non-U.S. franchise brand should utilize in the United States. Unlike the master franchise model that prevails outside the country, there are several alternative franchise relationship structures that franchisors can use in the United States, namely: (a) single unit franchise; (b) multi-unit franchise; (c) area developer; (d) area representative; and (e) joint venture.

Master franchising is less common in the United States because it usually involves dual regulatory

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requirements—i.e., both master franchisor and master franchisee must each have separate franchise disclosure documents (FDD), and the master franchisor relationship usually provides the master franchisor significantly less control over the master franchisee-sub franchisee relationship. There also are tax considerations in the United States that may drive the selected franchise model.

Federal and State Franchise Laws and Regulations. Assess the applicable U.S. franchise laws and regulations, which are different from those outside the U.S. There is a federal franchise law that governs all the states and mandates franchisors to prepare and disclose an FDD, but there is no federal filing or registration compliance requirement. There are also individual state franchise laws, among which 14 require that the franchisor comply with state disclosure and registration requirements. In addition, there are 25 states with business relationship statutes that may have additional state filing/notice requirements, especially if a franchisor does not own a trademark registration (federal or state).

The good news, at least for franchisors who may be fortunate to enter the U.S. under the right circumstances, is that both federal and state laws each allow for exemptions from their respective disclosure requirements and, in some states, the mandated registration requirements. The exemptions vary, but there are exemptions (subject to nuances in state law as well as the possibility of filing requirements in some cases) for large franchisees that meet a minimum net worth level (now \$7,348,000 under federal law). But, in New York there is no “large franchisee” exemption; however, other exemptions may be available. For example, New York has a large franchisor exemption based on the franchisor’s net worth; an isolated franchise sales exemption (i.e., franchisor offers and sells a single franchise to no more than two persons); and a “fractional franchise” sales exemption where a prospective franchisee has a

minimum level of experience in the same type of business as the franchisor and the new business will account for less than a certain percentage of the prospective franchisee's annual gross sales.

Trademarks. Regarding trademarks, a non-U.S. franchise brand may face obstacles in the United States that it did not have to face in its home country or other non-U.S. countries. It is crucial to first select a strong trademark to serve as the franchise brand to distinguish the franchise from competitors and give consumers a way to remember and recognize the franchise brand. Clearing the franchise brand prior to entering the United States and operating the franchise in the United States is crucial to ensuring that it can be safely adopted, used, and registered in the United States.

Since one earns trademark rights in the United States by use, not registration, it is important to conduct clearance outside federally registered trademarks and look to industry ("common law") uses in the marketplace or on the internet or social media. Words, names, logos, music, sounds, smells, characters, packaging, and trade dress (including unique store layouts like the Apple Store) make up several trademark forms available for protection in the United States. Once selected and cleared, a trademark(s) should be registered in the United State Patent and Trademark Office (USPTO). Non-U.S. franchise brands should also be aware that they can file for trademark protection in the USPTO based on their filed foreign trademark application (within six months of filing) or their issued foreign registration (without having to show use in the United States, although after three years such a registration could be cancelled for non-use in the United States).

Other Intellectual Property Assets. In addition to trademarks, franchisors should not ignore their copyrights, trade secrets, and patents. Assess whether you can protect this intellectual property in the United States or, on the flipside, whether the franchisor faces any infringement risks from using

those assets in the United States. Copyright protects any form of original expression found in many franchise assets such as menus, advertising, graphic design, photos, architectural designs, software applications, and operations and training materials. Registration in the U.S. Copyright Office is not required for copyright protection in the United States, but it is required to bring a lawsuit for copyright infringement. If you timely file for a copyright within three months of its publication, you may seek statutory damages and attorney fees if you prevail in your infringement action.

Trade secrets are another device for franchisors to use to protect that which may be covered by a patent or a copyright. To own a trade secret, a franchisor and its franchisees/employees must define the trade secret and maintain and keep it, and all related information, secret/confidential. Trade secrets are not registered but can be protected under federal law and some state laws.

While not a frequently used asset in franchising, utility patents can protect novel inventions for mechanical and electrical products and processes that your franchise may develop or use, and design patents can protect the ornamental appearance of original product designs or packaging/signage used in your franchise business. Applications for any patent are filed in the USPTO and must be filed within the first year after the invention seeking protection is made, offered, or sold in or outside of the United States. Be advised that all intellectual property licensed to the franchisee must be disclosed in Item 13 and Item 14 of the FDD.

Other U.S. Legal and Business Considerations.

Franchisors should be prepared for other laws that may impact their business in the United States. In addition to the federal and state tax laws noted above, federal antitrust laws (Sherman Act/Clayton Act) and the Federal Trade Commission Act regulate and require fair competition/truthful advertising and render invalid any business activity that serves as a

restraint on trade. Many states have franchise relationship laws and unfair competition acts and state antitrust laws, as well as laws that regulate pricing, noncompetition, and non-solicitation arrangements. Other federal and state laws governing employment/labor relationships and privacy/data security also need to be assessed to ensure that a franchise is structured to operate in compliance with such laws.

Before you heavily invest in your franchise brand in the U.S., take the time to consult with marketing/industry professionals to make sure your franchise and brand fit in the marketplace, which hosts many distinct cultures, languages, and customs. Consider opening pop-up stores or corporate owned stores to test the market and consumers for acceptance of your franchise brand, product, or service.

The U.S. market for non-U.S. franchise brands can certainly be lucrative, but it is also challenging. Non-U.S. franchise brands should take the time to plan ahead and develop a strong, detailed strategy for entering the U.S. market that accounts for its multicultural marketplace spanning the 50 states, the different federal and state laws and regulations, and protection for the variety of intellectual property assets that a franchise will need to monetize those assets via franchising in the United States.

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