Fractional Franchise Exemption: Friend or Foe?

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On its face, the fractional franchise exemption appears simple: if a prospective franchisee is in the same type of business as the franchisor and the franchised business will account for less than 20 percent of the prospective franchisee's gross sales, the franchisor has freed itself of its disclosure obligation on a federal, and sometimes state, level. Or is it that simple? This article will explore the many facets of the fractional franchise exemption. Why would a franchisor choose to use the fractional franchise exemption? What are its drawbacks? Is it available in all of the franchise registration states? This article will compare the federal and state fractional franchise exemptions, look at the use of the exemption in practice, and suggest some drafting tips for those who, at the end of the analysis, are still willing to utilize this exemption.

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Exemptions from the FTC Rule have obvious benefits. For example, eliminating the time-consuming, expensive Franchise Disclosure Documents (FDDs) is appealing. The creation of an FDD takes an enormous amount of executive time and resources, financial or other, which conceivably could be better deployed elsewhere. The mandated FDD serves a good purpose, i.e., protecting against unscrupulous franchisors taking advantage of less sophisticated prospective franchisees that would otherwise not fully understand the nature of the investment they are making or the obligations they are undertaking. However, prospective franchisees come to franchising with varying levels of sophistication. Through the adoption of sophisticated investor exemptions, including the fractional franchise exemption, the Federal Trade Commission (FTC) and many states have recognized that FDDs may not always serve a useful purpose for certain classes of franchisees.[1]

In some cases, relying on exemptions, including exemptions like the fractional franchise exemption, can have serious drawbacks. For example, in several registration states, some exemptions apply only to registration and not to disclosure, which can reduce their value significantly. However, with respect to those registration states that have a specific exemption or exclusion for a fractional franchise, the franchisor would be exempt from both registration and disclosure.[2]

However, the use of exemptions also requires the franchisor to maintain absolute sales discipline. Franchisee-centric exemptions, such as the fractional franchise exemption, must be analyzed case by case to determine the applicability of the exemption. Not all deals are possible under an exemption program. There will be candidates that simply do not meet the exemption criteria. Accordingly, franchisors may be faced with the choice of walking away from deals or complying with the applicable registration and disclosure laws.

Surprisingly, despite the frequent use of the fractional franchise exemption, particularly in certain types of businesses, and the numerous FTC Advisory Opinions addressing the exemption, there is a dearth of case law on the subject. The authors were unable to locate any reported decisions involving the exemption. The lack of reported decisions may have several possible explanations. Perhaps practitioners may be unaware of the exemption's availability, or perhaps the lack of uniformity of federal and state laws, including the lack of the exemption in some states, is a factor. Perhaps the numerous differences among the approaches employed by the states deter franchisors from relying on the exemption. The offering may, in some states, still risk being subject to state business opportunity laws, so that may be another factor. The requirements of the exemption also may be too limiting (for example, a sale to a prospective franchisee with less than twenty-four months' experience would be ineligible).

It also may be that if a fractional franchisee does derive more than 20 percent of its income from the franchise, the franchisee may be less likely to complain about higher than anticipated sales. The lack of case law might simply reflect the lack of clear guidance and answers to questions necessary for franchisors and practitioners to feel comfortable

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relying upon the exemption. Or the lack of opinions might reflect the early settlement of disputes before they reach the published decision stage. It is also possible, in some cases, that neither the franchisor nor the franchisee realizes that it has entered into a franchise agreement, and thus lawsuits regarding such agreements may not raise the franchise issues. Whatever the reason and despite its limitations, a fractional franchise can be an effective tool under appropriate circumstances and can provide advantages without some of the constraints, delays, and expense of the franchise disclosure and registration requirements.

HISTORY AND RATIONALE

The fractional franchise exemption was part of the original FTC Rule (Original FTC Rule) and was defined as

> any relationship . . . in which the person described therein as a franchisee, or any of the current directors or executive officers thereof, has been in the type of business represented by the franchise relationship for more than 2 years and the parties anticipated, or should have anticipated, at the time the agreement establishing the franchise relationship was reached, that the sales arising from the relationship would represent no more than twenty percent of the sales in dollar volume of the franchisee.[3]

The definition under the amended FTC Rule (Amended FTC Rule or FTC Rule) is similar to that under the Original FTC Rule[4] but was modified to state specifically that a "reasonable basis" must exist for the sales estimate and that the sales will be based on the first-year sales of the business.[5] The original definition also was expanded in the Amended FTC Rule to provide that a franchisor may consider the prior experience of an officer or director of an affiliate or parent of the franchisee. Thus, the Amended FTC Rule added greater precision and specificity by incorporating concepts that previously were implied by the Original FTC Rule and that were set forth in Informal Advisory Opinions issued prior to the Amended FTC Rule. Because the fractional franchise exemption under the Amended FTC Rule was revised to incorporate the concepts and ideas developed by the Informal Advisory Opinions interpreting the Original FTC Rule fractional franchise exemption, those opinions remain relevant to the interpretation of the fractional franchise exemption today.

The fractional franchise exemption is very narrowly tailored and is based on the premise that a fractional franchisee is essentially adding an extra line of products or services to an existing operation.[6] Each of the two elements of the exemption—that the new line of products or services be in the same business that the franchisee is already in and that the new line is not expected to account for more than 20 percent of the franchisee's total sales—conceivably mitigates the risks involved in entering into a new business venture. Because of the same business requirement, a franchisee in a fractional franchise relationship usually will be familiar with the costs, profits, and potential problems of distributing similar goods and services.[7] The franchisee's experience also reduces its dependence on the expertise of the franchisor and reduces the risk of the franchisor misleading the franchisee. In addition, because at least 80 percent of the franchisee's sales are derived from other products or services, the franchisee is not substantially dependent on the sales of the franchised products for its success.[8] The franchisee usually retains its individual business identity, making an exit from the fractional business easier.[9] If the relationship with the franchisor sours or proves unsuccessful, the franchisee survives as an independent entity. It retains any goodwill established from operating its own business and readily can continue in business as it did before entering into the franchise relationship.[10]

EXAMPLES OF FRACTIONAL FRANCHISES

Fractional franchises are not limited to any particular segment of the economy and conceivably could fit into many different types of franchise settings, such as food service; health care; employment agencies; construction; and, as reflected in the numerous FTC Informal Advisory Opinions on the subject, many others. Among the examples in those opinions are franchise relationships as varied as affiliation arrangements between a national commercial real estate company and regional brokers,[11] productivity centers for temporarily disabled workers,[12] technology integration services,[13] rehabilitation services to be operated as part of hospitals,[14] trade associations,[15] and systems for health screening of employees offered to health care providers.[16] Some recent examples of other arrangements that conceivably could be treated as fractional franchises under appropriate circumstances are 1-800-DENTISTS, a patient referral network for dentists, and a scaled-down sandwich franchise selling grab-and-go meals in convenience stores.

One of the most visible and widespread fractional franchise programs has been undertaken by Starbucks Corporation, with nearly 4,000 coffee shops located within existing establishments such as grocery stores, airports, hotels, and bookstores. Starbucks' licensing program was founded upon the fractional franchise exemption. Starbucks does not now, nor has it ever had, a Uniform Franchise Offering Circular or FDD. Starbucks accepts franchise applications from candidates that already own a business, such as a grocery store, in which a relatively low-cost kiosk can be installed into existing space. The franchisee incurs costs to purchase the kiosk and pays ongoing royalties and other fees to Starbucks, but the space itself within the existing structure, utility connections, and employees to staff the primary business are in place, permitting the franchisee to maximize revenue within the primary facility. Starbucks has in place a strict policy to comply with the fractional franchise requirements on a federal and state level. For example, it has been Starbucks' policy simply not to sell franchises to prospects in states with franchise disclosure laws that do not have a fractional franchise exemption and where other exemptions do

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PRACTICAL TIPS

A franchisor that wants to rely on the fractional franchise exemption must have a process to qualify and document the process of determining a franchisee's exempt status. Because exemptions are complex and nuanced, compliance requires judgment calls that should be made by experienced counsel. A franchisor may help ensure compliance with the franchise laws by gathering evidence to support its determination that the prospective franchisee meets the criteria for the fractional franchise exemption and by requiring prospective franchisees to submit a pro forma report or projections relating to gross sales at the franchised location.

A franchisor must accept that some franchise candidates will not meet the criteria. If the franchisor is unwilling to turn down prospective franchisees that do not meet the strict requirements of the FTC Rule and state statutes, the franchise system should not engage in exemption-based franchising or, at the least, must operate a traditional franchise program as a backup to its exemption-based program.

If there is not a fractional franchise exemption or if a discretionary exemption cannot be obtained from the appropriate state agency, a franchisor will not be able to sell franchises in states with franchise disclosure laws without registering or qualifying for another exemption. Franchisors may want to rely on other exemptions, if available, in those states, such as those dealing with sophisticated investors. However, some exemptions may apply only to registration and not disclosure.

Although some franchisors will want their franchisees to cobrand, in many instances a franchisor will want the fractional franchisee to continue using the franchisee's own name for its existing business operations. Although not practical in all circumstances and not a specific element of any of the definitions of a fractional franchise, if the franchisor is willing and able to limit practical and contractual impediments that may prevent the franchisee from disengaging from the relationship, such as by eliminating a noncompete and by permitting the franchisee to retain its existing customer base, the case for the fractional franchise exemption can be strengthened.

A franchisor should only charge royalties on the incremental income earned by a franchisee from the additional service or product (or possibly charge a flat fee) and should permit the franchisee to continue operating the franchisee's core business upon expiration or termination of the fractional franchise portion of the business.

not apply to the Starbucks model. Plainly, in-line fractional franchising as practiced by companies such as Starbucks, Marriott, and big-box retailing (e.g., a Pizza Hut in a Target store) has real utility in franchising.

FEDERAL EXEMPTION

Even if a fractional franchise relationship is covered by the FTC Rule because it satisfies the definition of a franchise,[17] it will qualify for the federal fractional franchise exemption if the prior experience and anticipated sales estimate criteria are satisfied. A fractional franchise is defined in the Amended FTC Rule[18] as a franchise relationship that satisfies the following criteria when the relationship is created:

- The franchisee, any of the franchisee's current directors or officers, or any current directors or officers of a parent or affiliate have more than two years of experience in the same type of business.
- The parties have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20 percent of the franchisee's total dollar volume in sales during the first year of operation.[19]

As with all exemptions, the burden of proving that the prerequisites are met rests with the franchisor.[20] Because the exemption is based on the experience and sales of the prospective purchaser, it can be referred to as a "franchisee-centric" exemption. It is quite possible that a franchise would be a fractional franchise if sold to one prospect but would be considered a traditional, nonexempt franchise if sold to a different prospect. A franchisor must have criteria to determine what *same type of business* means for its franchise program and what type of experience is necessary for the franchised concept. The franchisor must document that the prospective franchisee qualifies under that criteria for each deal. If the arrangement satisfies the two elements of a fractional franchise, compliance with presale disclosure requirements of the FTC Rule will not be required.

"SAME TYPE OF BUSINESS" REQUIREMENT

The franchise satisfies the same type of business requirement under the FTC Rule if the franchisee sells competitive goods or services or is engaged in a business that ordinarily would be expected to sell the type of goods or services to be distributed under the franchise.[21] Although the experience need not be in an identical business, the exemption may not apply if the experience is simply from the same general industry of the opportunity.[22] Again, the rationale of the exemption, i.e., that fraud is less likely when a franchisee has experience in the same business, is not present if the franchisee's experience is simply from the same industry.

The Interpretive Guides to the Original FTC Rule explained the exemption in terms of a business owner who adds the fractional franchise product line to its existing business.[23]

> For example, a hardware store may expand its line of goods by offering lawn care equipment. Even though the hardware

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store owner may never have sold lawn care equipment before, he still will be "in the business" represented by the franchise because hardware stores commonly carry such goods and can be expected to have some familiarity with comparable goods.[24]

On the other hand, the FTC's conclusion was different for a muffler shop owner who is offered a quick-lube franchise. Although the two businesses could be described as being in the same industry, the FTC did not view them as being in the same business and questioned whether experience from one of the businesses would be sufficient to avoid potential fraud on the franchisee when it acquired the other type of business.[25] The hardware store and muffler shop examples demonstrate one of the reasons why it is so challenging to use the fractional franchise exemption. According to examples cited in the FTC Compliance Guide (Guide), an independent ice cream store owner might qualify as a fractional franchisee if it were to enter into a franchise relationship with an ice cream cake supplier. However, the Guide further noted that an ice cream store owner would probably not qualify if it expanded the product line to include greeting cards because greeting cards are not typically found in ice cream stores.[26]

The fractional franchise exemption typically applies where an existing business expands to include additional product lines or services.

What is the qualitative difference between changing oil and changing a muffler? Is it that different from an Ace Hardware franchisee adding a John Deere franchise to its business? Will the addition of sub sandwiches to the menu of a pizzeria qualify as a fractional franchise? What if the add-on to the pizza concept is frozen yogurt? There is no genuine guidance on this, leaving the franchisor, or typically its outside or in-house counsel, relying on intuition when making the call. However, the FTC refused to extend the exemption to "complementary goods" when writing the Amended FTC Rule, noting that

> [w]hat may be viewed as "complementary goods" in any particular line of business may be quite subjective. For example, reasonable minds may differ whether the introduction of ice cream sales at a donut/coffee shop is "complementary." While certain products may make complementary sales combinations—such as ice cream and donuts—it does not necessarily follow that a donut shop franchisee is experienced with the risks involved with marketing and selling ice cream.[27]

It is unclear to the authors why the addition of lawn care equipment to the product assortment of a hardware store is considered a new line of business while ice cream sold at a donut shop is deemed a complementary good that may not fit within the fractional franchise exemption.

To satisfy the business experience requirement, the franchisee actually must have been in the type of business represented by the franchise. This concept is illustrated in an Informal Staff Advisory Opinion regarding a vending machine manufacturer that had sold vending machines to a law firm for the firm's own use.[28] Two years later, the law firm invested in more machines, relying on the manufacturer's business assistance to help it locate other firms that might be interested in purchasing machines. The advisory opinion addressed whether the new relationship between the manufacturer and the law firm qualified for the fractional franchise exemption. Plainly, the revenue from the machines was less than 20 percent of the law firm's revenue, so at issue was only whether the law firm satisfied the same business requirement of the exemption. The opinion stated that "it cannot reasonably be said that the law firm or one of its employees, was in the 'vending business,'" noting that using a vending machine for private use is not the same as being in the business of offering and selling vending machines and related services to the public.

As is illustrated by the above examples, it may be very hard to draw the line between what is the same business and what is not. Presumably, a nail salon owner would be exempt for the addition of a waxing franchise to the salon, given that those sorts of services are commonly seen in such establishments. However, would the salon also be permitted to offer facials or massages? With the current lack of guidance, it is hard to tell.

The fractional franchise exemption typically applies where an existing business expands to include additional product lines or services. Nevertheless, it may apply to an affiliation arrangement where the franchisee's business grows by expanding its traditional market rather than by adding product lines or new services. An affiliation arrangement is in some respects analogous to a conversion franchise. However, one of the difficulties with using the fractional franchise exemption for such an arrangement is that in an affiliation arrangement, income generated from the sale of goods, and especially services, may be fungible. Therefore, it may be difficult for the parties to segregate that portion of the income that would be generated in the absence of the affiliation from that incremental portion generated as a result of the affiliation.

Two Advisory Opinions analyze affiliation arrangements in the context of a fractional franchise. In spite of seemingly similar arrangements in some respects, the outcomes were different.

The first opinion involved a chauffeur service.[29] Although the franchisor tried to describe its proposed franchise to the FTC as a fractional franchise, the FTC interpreted it more as akin to a conversion franchise. The franchisor intended to target experienced independent drivers who would adopt the franchisor's name and use the franchisor's service mark. The franchisor would only charge royalties on revenue that exceeded the driver's gross revenue from the previous year (the incremental income from the affiliation). Among the

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reasons the FTC opined that the arrangement did not satisfy the requirements of a fractional franchise were the following: (1) the identity of the individual driver's business would be terminated because the driver would operate under the franchisor's trade name, and any prior, independently established goodwill would be substantially diminished; (2) it was unclear whether a driver might readily resume business if the affiliation arrangement were terminated or whether a noncompetition clause would apply after termination; (3) it was unclear whether the licenser or the driver would own the rights to provide services to repeat clients; (4) the driver was subject to a limited territory restriction; (5) the driver might find that his "line of business," i.e., the provision of chauffeur services, might actually decrease rather than expand as a result of this restriction; and (6) the driver was obligated to pay royalty and advertising fees. Taking all of those factors into account, the FTC determined that an independent chauffeur driver was not "in the business represented" by the licenser's affiliate arrangement and that new restrictions and obligations created additional risks for the driver above and beyond what he faced as an independent driver.[30]

In the second opinion,[31] rendered two years later, the FTC determined that an affiliate of CB Commercial Real Estate's affiliation program could qualify for the exemption, perhaps proving the point that size, or the perceived sophistication of the prospective franchisee, really does matter. In an opinion that predated the sophisticated investor exemption, a wholly owned subsidiary of CB Commercial Real Estate, Inc. wanted to franchise its concept to one or two highly successful commercial real estate brokers with an income of at least $1 million in those markets where it did not have a presence.[32] In making its determination, the Commission considered the following factors:

- whether the franchisee is experienced enough to understand the risks that likely will arise when switching from an independent business to an affiliated business;
- whether there are "contractual impediments that may prevent the franchisee from disengaging from the affiliation relationship," such as "whether the affiliate retains its own goodwill and its own client base"; "whether the affiliate has other sources of income"; and "the extent to which the affiliate is subject to covenants not to compete or other post-term restrictions";
- "whether the parties have reasonable grounds to anticipate that the affiliate's income will increase by less than twenty percent due to the affiliation"; and
- whether affiliates "will make royalty payments based upon the difference between their sales before and after entering the affiliation arrangement" rather than making royalty payments on income from the entire business.[33]

Some of the main differences between the chauffeur advisory opinion and the realtor advisory opinion are that the realtor franchisees were to co-brand their businesses while maintaining their existing names as opposed to using the franchisor's trade name alone; the realtor franchisees likely were sophisticated businesspeople; and, in the realtor opinion, the exemption request was phrased in such a way as to make it clear that it would be easy for the franchisees to disassociate from the franchise.

LOCATION OF THE ANCILLARY BUSINESS

For purposes of the federal exemption, the nature of the business, not its location, is the critical factor. Although the location of the business "is one factor [FTC] will consider in determining the similarities and differences between" the franchisee's existing business and the new business, the fact that a fractional franchise may be operated out of a different facility will not, in and of itself, destroy the exemption.[34] However, as noted below, the answer is different under some state laws.

WHO SATISFIES THE SAME TYPE OF BUSINESS REQUIREMENT?

Under the FTC Rule, the same type of business experience element can be satisfied as long as the franchisee or any of its current directors or officers, or any current directors or officers of an affiliate or parent, have the requisite experience.

Although not specifically stated in the FTC Rule, the experience requirement also can be satisfied by a partnership, a partnership's general partners, a limited liability company, or the managers of a limited liability company.[35] The principal factor in applying the fractional franchise exemption is whether the business seeking to expand can obtain practical guidance and direction from someone within the business with prior experience. Franchisees may establish subsidiaries for limited liability or tax purposes or other reasons unrelated to the actual management of entities within the group.[36] In such instances, the FTC believes that because operations of the franchisee and its parent, subsidiaries, or other affiliates are likely to be close, the prior experience of one is available to help direct the business decisions of the other.[37]

One possible solution for prospective franchisees that do not have requisite experience themselves may be to engage a management company to operate the franchise for them. For example, in the case of a hospital wanting to add a fast-food restaurant, the hospital may engage a food service management company and lease the space for the restaurant to the food service management company. This business arrangement also may work in the hospitality industry, where a hotel management company holds the franchise and manages the hotel for the owner.[38]

WHEN IS THE BUSINESS EXPERIENCE SATISFIED?

In contrast to some of the state laws discussed below, the Amended FTC Rule is silent about whether the two-year experience requirement can be satisfied at any time in the past. However, the Interpretive Guides to the Original FTC Rule explicitly state that the two-year experience may be at any time in the past.[39]

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DRAFTING SUGGESTIONS

The availability of the fractional franchise exemption is fact-based. Although drafting alone will not be sufficient to satisfy the exemption, careful drafting can aid in supporting the basis for the exemption and protecting a franchisor from claims of franchise disclosure violations. The following sample provisions are based on the FTC Rule and may need to be adapted to conform with certain state laws.

Long Form

YOUR EXPERIENCE AND REPRESENTATIONS. You expressly acknowledge and understand that the representations made by you in this Section constitute a condition for our decision to enter into this Agreement and that if the following statements are not accurate or not based on your good faith judgment, that shall constitute a material breach of this Agreement. You recognize that we are relying upon the following representations in entering into this Agreement and basing our ability to fall within the exemption from franchise registration and/or disclosure under the "fractional franchise" exemption and exemptions from "business opportunity laws," and, to the extent permissible under applicable law, you hereby waive your rights under any franchise, business opportunity, or similar laws.[1]

1. You already operate a business similar to that of the Franchised Business, and the business to be conducted under this Agreement will not constitute the starting of a new business but rather an expansion and/or enhancement of your current business. You have determined that the success of your core business is not dependent on the new product line or service that you are adding to your Current Business.
2. For at least 24 months immediately prior to the date of this Agreement, you, or if you are not a natural person, an existing officer, director, or managing agent of you, your parent, or one or your affiliates who has held that position with you, your parent, or your affiliate, as the case may be, for at least the last 24 months, have/has been engaged in a business offering services similar or related to the Franchised Business.
3. You have made a good faith determination that during the first year of operations of this franchise, your projected revenues generated from the Franchised Business will not exceed 20 percent of your gross revenues from your existing business combined with the Franchised Business, and you have a reasonable basis for such determination. You acknowledge that you are capable of performing an analysis of historical and projected earnings or a market analysis or otherwise demonstrating that you can derive 80 percent of your income independent of the relationship contemplated by this Agreement during the first year of operations of the Franchised Business.
4. You are experienced and knowledgeable in your existing business and recognize that any controls or assistance that will be provided to you by us will relate only to the Franchised Business of your business and not to the operation of any of your other business activities, such as your Current Business.

Short Form

You represent and acknowledge that you and/or any of your officers or directors have been in the same type of business for a minimum of two years immediately before entering into this Agreement and that you and we, after a thorough analysis of historical data and other market data available to us, anticipate that sales from the Franchised Business will not exceed 20 percent of your total sales during the first year of operation and that the Franchised Business is thus exempt from disclosure under 16 C.F.R. § 436.8(a)(2) and any applicable state disclosure law.

ENDNOTES

1. The FTC Rule as well as many state franchise and business opportunity laws have antiwaiver provisions that would invalidate a waiver.

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HOW IS "TOTAL DOLLAR VOLUME OF SALES" DETERMINED?

In addition to the uncertainties surrounding the analysis of the meaning of *same type of business* under the fractional franchise exemption, there is another challenge once that hurdle has been cleared: calculating how much of the prospective franchisee's total revenue will likely be generated from the fractional franchise. To qualify for the exemption, the parties must, at the time that they enter into the relationship, anticipate that "no more than 20 percent of the prospective franchisee's business in terms of dollar volume of goods or services to be sold or distributed by the franchisee" in the first year of business will be derived from the fractional franchise.[40] Franchise practitioners, who are accustomed to advising their clients scrupulously to avoid making projections and predictions of future performance, may find such an analysis counterintuitive. Franchisors almost universally use historical data to prepare financial performance representations because of the inherent risks of making projections that fail to materialize.[41] Likewise, such analysis may be challenging to businesspeople who, excited by a new opportunity, may have a difficult time being objective about sales numbers.

The 20 percent exemption test is measured in terms of "dollar volume," as opposed to the "number of goods and services sold."

The Statement of Basis and Purpose for the Original FTC Rule discussed the use of "dollar volume," as opposed to the "number of goods and services sold," as the appropriate measurement. This is important especially where the fractional franchise is a business in which a large number of products are sold at a low cost and will be added to the business of a franchisee whose other business consists of selling few, expensive items. The Guide states that

> the parties may measure incremental sales resulting from the fractional franchise against total sales at all stores owned by the franchisee (franchised or non-franchised). For example, an individual owning several hardware stores may introduce a new product at one store only. The store owner should measure the increase in sales attributed to the new product against the aggregate total sales volume for all products sold through his or her businesses.[42]

The FTC will consider whether both parties are capable of demonstrating that the franchisee can derive 80 percent of its income independent of the franchise relationship.[43] The exemption places responsibility on both the franchisor and the franchisee to have the capacity to make a reasonable good faith determination of the projected revenues of the franchisee. As a practical matter, the franchisor is the one ultimately responsible for compliance with federal and state franchise laws; however, the franchisee's input can serve as a defense against fraud claims asserted by the franchisee against the franchisor. The FTC "will consider whether the parties have a good faith basis to support their claim. For example, [it] will consider whether both parties are capable of performing an analysis of each [party]'s historical and projected earnings, a market analysis, or otherwise demonstrating that [the franchisee] can derive eighty-percent of its income independent" of the franchised business being offered.[44] The FTC will expect the parties invoking this exemption to take into account in good faith the franchisee's anticipated sales for a period of at least one year after the franchisee begins selling the goods or products involved in the franchise. An Informal Advisory Opinion determined that the 20 percent test was satisfied where the franchisor required prospective licensees to "prepare projections of the amounts and sources of their revenue for one year," and the franchisor examined and evaluated the reasonableness of the projections before accepting them.[45] Again, in defending a claim that the franchise sale was not exempt, documentation of the franchisee's representations to the franchisor on this issue is critical. On the other hand, a bald allegation that the parties anticipate that income will not exceed the threshold may be an insufficient basis to support reliance on the fractional franchise exemption, although receiving a written statement to that effect from the franchisee, even without sufficient substantiation, may be helpful when litigating fraud claims.[46]

Historical information to demonstrate what portion of a franchisee's revenue is derived from the franchise is very helpful in the analysis, but, in many cases, it may be unavailable. If sufficient historical information is not available, the parties must be able to justify the reasons that they believe the franchisee likely will not derive more than 20 percent of its business through the fractional franchise. Many different sources may provide the experience that will support the basis for calculation of the revenue that a business will generate. For example, in one instance the FTC has acknowledged that information about performance of a franchise system in the European market could be used as the basis for anticipating performance in the U.S. market,[47] and another noted that past experience could be used.[48]

Where the franchisor asserted that the benefits of an affiliation program were likely to be realized over a period of time well in excess of a year and where the prospective franchisees were sophisticated and had substantial knowledge of the industry and costs and benefits of the franchisor's programs, an Informal Advisory Opinion determined that there appeared to be a good faith basis that the franchisee's gross sales would not exceed 20 percent in the first year.[49]

Beyond such general guidance, however, little has been written on this topic. How detailed do the projections have to be? What basis must the parties have for their projections? It is clear that the parties do not need to involve an

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REGISTRATION STATES: DEFINITION OF "FRACTIONAL" FRANCHISE *	
State	**Definition of Fractional Franchise**
California	Any offer or sale of a franchise if the franchise involves the adding of a new product or service line to the existing business of a prospective franchisee, provided all of the following requirements are met: (a) For at least the last 24 months prior to the date of sale of the franchise, the prospective franchisee, or if the prospective franchisee is not a natural person, an existing officer, director, or managing agent of the prospective franchisee who has held that position with the prospective franchisee for at least the last 24 months, has been engaged in a business offering products or services substantially similar or related to those to be offered by the franchised business. (b) The new product or service is substantially similar or related to the product or service being offered by the prospective franchisee's existing business. (c) The franchised business is to be operated from the same business location as the prospective franchisee's existing business. (d) The parties anticipated, in good faith, at the time the agreement establishing the franchise relationship was reached, that sales resulting from the franchised business will not represent more than 20% of the total sales in dollar volume of the franchisee on an annual basis. (e) The prospective franchisee is not controlled by the franchisor. (f) The franchisor files with the commissioner a notice of exemption and pays the fee prescribed in subdivision (f) of Section 31500 prior to an offer or sale of such a franchise in this state during any calendar year in which one or more of those franchises are sold.
Hawaii	No statutory exemption for fractional franchise.
Illinois	A "fractional franchise" means any relationship in which the person described therein as a franchisee, or any of the current directors or executive officers thereof, has been in the type of business represented by the franchise relationship for more than 2 years and the parties anticipated, or should have anticipated, at the time the agreement establishing the franchise relationship was reached, that the sales arising from the relationship would represent no more than 20% of the sales in dollar volume of the franchisee for a period of at least one year after the franchisee begins selling the goods or services involved in the franchise.
Indiana	The franchisee, or any of its officers or directors at the time the contract is signed, has been in the type of business represented by the franchise or a similar business for at least two (2) years, and the parties to the contract anticipated, or should have anticipated, at the time the contract was entered into that the franchisee's gross sales derived from the franchised business during the first year of operations would not exceed twenty percent (20%) of the gross sales of all the franchisee's business operations.
Maryland	No statutory exemption for fractional franchise.
Michigan	The transaction complies with all of the following: (i) The prospective franchisee is presently engaged in an established business of which the franchise will become a component. (ii) An individual directly responsible for the operation of the franchise, or a person involved in the management of the prospective franchise, including but not limited to a director, executive officer, or partner has been directly or indirectly engaged in the type of business represented by the franchise relationship for at least 2 years. (iii) The parties have reasonable grounds to believe, at the time the sale is consummated, that the franchisee's gross sales in dollar volume from the franchise will not represent more than 20% of the franchisee's gross sales in dollar volume from all of the franchisee's combined business operations.
Minnesota	Any franchise relationship in which the franchisee or any of the principal officers or directors of the franchisee, have been in the type of business represented by the franchise relationship for more than two years and the parties anticipated, or should have anticipated, at the date of the agreement establishing the franchise relationship, that the sales arising from the relationship would represent no more than 20% of the dollar sales volume of the franchisee.

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REGISTRATION STATES: DEFINITION OF "FRACTIONAL" FRANCHISE *	
State	**Definition of Fractional Franchise**
New York	Any offer or sale of a franchise, if the franchise involves the adding of a new product or service line to the existing business of a prospective franchisee, is exempt from registration provided all of the following are met: (a) For at least the last 24 months prior to the date of sale of the franchise, the prospective franchisee, or if the prospective franchisee is not a natural person, an existing officer, director, or managing agent of the prospective franchisee who has held that position with the prospective franchisee for at least the last 24 months, has been engaged in a business offering products or services substantially similar or related to those to be offered by the franchised business. (b) The new product or service is substantially similar or related to the product or service being offered by the prospective franchisee's existing business. (c) The franchised business is to be operated from the same business location as the prospective franchisee's existing business. (d) The parties anticipated, in good faith, at the time the agreement establishing the franchise relationship was reached, that sales resulting from the franchised business will not represent more than 20% of the total sales in dollar volume of the franchisee on an annual basis. (e) The prospective franchisee is not controlled by the franchisor. (f) The franchisor notifies in writing the New York State Department of Law of the specific circumstances surrounding the fractional franchise exemption and pays the statutory fee for an amendment as prescribed in section 694.1(b) of the General Business Law.
North Dakota	No statutory exemption for fractional franchise.
Oregon	Same as federal.
Rhode Island	No statutory exemption for fractional franchise.
South Dakota	"Fractional franchise" is any franchise relationship that satisfies the following criteria when the relationship is created: (a) The franchisee, or any of the franchisee's current directors or officers, or any current directors or officers of a parent or affiliate, has more than two years of experience in the same type of business; and (b) The parties have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20% of the franchisee's total dollar volume in sales during the first year of operation.
Virginia	A franchise does not include a contract or agreement by which a retailer of goods or services is granted the right to utilize a marketing plan or system to promote the sale or distribution of goods or services which are incidental and ancillary to the principal business of the retailer (sales under such a plan or system accounting for less than 20% of the retailer's gross sales being deemed incidental and ancillary).
Washington	No statutory exemption for fractional franchise.
Wisconsin	Any relationship if the person described in the offer as a franchisee, or any of the current directors or executive officers of that person, has been in the type of business of the franchise relationship for more than 2 years and the parties anticipated, or should have anticipated, at the time the agreement establishing the franchise relationship was reached, that the sales arising from the relationship would account for no more than 20% of the gross sales revenue of the franchisee for a period of at least one year after the franchisee begins selling the goods or services involved in the franchise.

** This chart should not be a substitute for a thorough review of the statute, applicable law, and state regulations.*

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accountant,[50] but what research and analysis gives rise to a good faith belief? The answer may well depend on the sophistication and experience of the parties. Experienced businesspeople are making business projections every day to run their business as a going concern. It is unlikely that the law was intended to impose a requirement that the franchisor be absolutely certain that the 20 percent sales threshold limit will not be exceeded. Doing so would make the exemption virtually unusable and be contrary to even a literal reading of the federal exemption. At least under the FTC Rule, if the original estimate proves wrong and the franchisee's revenue exceeds 20 percent, the fractional franchise exemption will not necessarily be lost, provided that the franchisor has sufficient documentation to demonstrate the care and good faith of its original estimate.[51] Understandably, there may be instances where a franchisee unexpectedly will have a substantial increase in sales related to the franchise that result in exceeding the 20 percent threshold.

In the event that a franchisor undertakes an analysis of the franchisee's projections, it should not, under any circumstances, comment on these projections. Doing so runs the risk of making a financial performance representation. Even if the transaction is exempt, there are many Little FTC Act claims and common law fraud causes of action available for inaccurate financial performance representations. The qualification process is important, and the authors recommend that all such projections be carefully reviewed by counsel.

STATE FRANCHISE LAWS

Because the FTC has made it clear that the federal FTC Rule does not preempt state franchise laws other than where it imposes more stringent requirements,[52] a review of the fractional franchise exemption cannot end with the FTC Rule. The FTC Rule exemption is the law in all states that do not have their own state franchise disclosure legislation, but a number of states have disclosure laws that must be examined. Not all state franchise laws exempt fractional franchises. The definitions used in those states that have an express fractional franchise exemption or exclusion are, in many respects, quite similar. However, specific differences, some of which can be quite significant, are discussed below. As a result of these differences, in some circumstances a franchisor either must comply with the franchise disclosure requirements (and, where applicable, registration) or avoid selling in the states where the fractional franchise exemption is not recognized.[53]

FRANCHISE REGISTRATION STATES

The following states have franchise registration laws: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon,[54] Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.[55] Of these states, Hawaii, Maryland, North Dakota, Rhode Island, and Washington do not have a specific exemption for a fractional franchise, but other exemptions may be available in some of those states that will allow a franchisor to expand into those states on an exemption basis.[56]

Under the laws of Indiana, Illinois, and Virginia, a fractional franchise is specifically excluded from the definition of a franchise.[57] As a result, the exemption of the franchise is not only an exclusion from registration and disclosure but also from other statutory provisions. In other states that have the fractional franchise exemption, it is treated only as an exemption from the registration and disclosure laws, but the relationship laws, governing such aspects as renewal and termination of franchise agreements, may still apply to fractional franchises.

EXPERIENCE REQUIREMENT UNDER STATE LAWS

One interesting, but often troubling, difference between the various state exemptions, as well as the FTC's exemption, is how a franchisee can obtain the necessary business experience. Although all states require at least two years' prior experience in the same business and it appears that such experience must immediately predate entering into the franchise agreement, there is some inconsistency as to who must have the requisite experience. If the franchisee is an individual, it is clear, both under the FTC Rule and the state exemptions, that the experience must be that of the individual franchisee. Where the franchisee is an entity, there is less consistency. The FTC Rule, for example, permits the experience to be with an officer or director of the franchisee, an affiliate, or a parent. California permits the experience to be that of a director, officer, or managing agent.[58] In Illinois, it has to be that of an executive officer or a director.[59] In Michigan, it must be that of an individual directly responsible for the operation of the franchise or involved in the management of the franchise.[60] Minnesota requires that the experience be with a principal officer or director.[61] Because most states provide that the positions must be held with the franchisee itself, at least based on a literal reading of the statutes, there may be a question as to whether or not experience with an affiliate or parent is sufficient.

The Virginia exemption is unique in that it does not have the customary two-year experience requirement element but simply requires that the fractional franchise is for "the sale or distribution of goods or services which are incidental and ancillary to the principal business of the retailer (sales under such a plan or system accounting for less than twenty percent of the retailer's gross sales being deemed incidental and ancillary)."[62] It is unclear from the definition whether the retailer is a physical person or if it can be a business entity. Though presumably the Virginia exemption may apply to a retailer that has been in business for a very short time, it appears that the statute requires the same business requirement be satisfied for the specific individual or entity that is the prospective franchisee.

This interpretation of the Virginia statute ties into another nuance of the experience requirement that can be found in the California and New York statutory exemptions. In California and New York, for franchisees that are entities, it is not enough that an existing director or officer has at

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least twenty-four months of experience in the same business; the director or officer must have held that position with the franchisee for the twenty-four-month period preceding the execution of the franchise agreement. Implied in this condition is that the franchisee entity itself must have been in the same business as the offered franchise for the prior twenty-four-month period. In other words, a franchisee cannot simply hire someone with the requisite experience to satisfy the experience requirement for the fractional franchise exemption as it could do if the FTC Rule controlled.

ADDITIONAL ISSUES UNDER STATE LAWS

Location of the business is an additional issue under the state laws. As noted above, under the federal FTC Rule, the fact that a fractional franchise may be operated out of a different facility than the franchisee's core business is not, by itself, disqualifying. As a result, under the FTC Rule, an existing franchisee that operates in one state conceivably could open another location for the same franchise system in another state without the franchisor being required to register in that state, presuming that the new business is reasonably anticipated not to exceed 20 percent of the franchisee's total sales in the first year and, of course, presuming that the state in question is not a registration state with a more restrictive (or no) fractional franchise exemption.

However, under some state laws, if the businesses do not operate out of the same location, the fractional franchise exemption would not be available. The California and New York statutes provide that the franchised business must be operated out of the same location as the franchisee's existing business, and the Michigan statute requires that the franchised business become a component of the existing business.[63] Questions conceivably could arise as to what is meant by *the same location*. For example, if a retailer leases an adjoining space in a mall to accommodate its anticipated increase in business, would that be the same location? What if the spaces in the mall are not contiguous?

The same location requirement significantly narrows the scope of the state fractional franchise exemption. For example, a regional franchisor in the Midwest that has not sold franchises for a few years and does not have an updated FDD may have a large franchisee with several profitable locations. If that franchisee wishes to expand its operations to Georgia, it is possible that the federal fractional franchise exemption would apply (assuming the new Georgia operations are not expected to exceed 20 percent of the franchisee's total dollar volume in the first year of operations). However, under these circumstances, where the franchisor does not need a state exemption, the franchisor should consider using the large-franchisee exemption or sophisticated investor exemption now available under the Amended FTC Rule, given that those exemptions require less judgment in execution.

But if the large franchisee instead wanted to expand to California, the state law requirement that the fractional franchise be operated out of the same location as the large franchisee's existing business would prevent the fractional franchise exemption's applicability. The franchisor would have to update its FDD and register in California before the sale could be completed, or use one of the many other exemptions available to the franchisor in California.

Control is an additional issue under state law. The California and New York exemptions require that the franchisee not be controlled by the franchisor. There is no guidance as to the meaning of this element of the definitions. It is possible that the legislatures simply wanted to convey that the nature of a fractional franchise is such that the franchisee is not staking its entire business and livelihood on the franchisor's assistance. If so, the control language adds little to the federal definition.

A distinction between wholesalers and retailers is an issue under the Virginia statute. Although the federal fractional franchise exemption and those exemptions available under state laws usually do not distinguish between wholesalers and retailers, the Virginia statutory exemption requires that the 20 percent of sales be based on the retailer's gross sales.[64] Therefore, the exemption may not be available to wholesalers in Virginia.

With respect to Michigan, sales of combined business operations are an issue. The 20 percent calculation in Michigan is based "from all of the franchisee's combined business operations,"[65] which conceivably means that the franchisee can base its 20 percent calculation on its revenues from any business in which it has an interest, even if that business is unrelated to the business contemplated by the fractional franchise. Both the FTC Rule and the other state laws are not as explicit.

The Michigan law is unique for another reason as well. Even if the arrangement meets the definition of a fractional franchise, if an FDD has been prepared by the franchisor for use in another state, the franchisor must give a copy of the FDD to a Michigan prospect.[66]

FILING REQUIREMENTS

Except for California and New York, the fractional franchise exemption is automatic and does not require any filing. Only California requires annual renewals.

Although the FTC Rule bases the fractional franchise on a good faith determination that the sales for the first year of business will be no more than 20 percent, California, Michigan, and New York require that the calculation be made based on the franchisee's expected revenue during each year in which the franchise arrangement exists. Virginia also requires that the franchisee's sales of the franchised products or services actually account for no more than 20 percent.

Hawaii, Maryland, North Dakota, Rhode Island, and Washington do not have statutory exemptions for fractional franchises. However, in Hawaii, Maryland, and North Dakota, a discretionary exemption might be available, as described below.

In Hawaii, the director may by rule or order exempt a franchise from disclosure and registration requirements if he deems it in the public interest to do so after reviewing information from the franchisor. At the present time, the director does not necessarily

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grant such an exemption solely on the basis that it satisfies the elements of the federal fractional franchise exemption.

In Maryland, the Regulations[67] permit the grant of exemptions by order if the commissioner determines that "(a) [t]he transaction or class of franchises is not one within the purpose of the Maryland Franchise Law; and (b) [r]egistration of the transaction or class of franchises is not necessary or appropriate in the public interest or for the protection of franchisees."[68] In practice, the commissioner generally will grant an exemption for a franchise that satisfies the criteria as a fractional franchise under the FTC Rule promptly upon a request being filed in accordance with the requirements specified in the Regulations. If an exemption from registration is granted, Maryland will not require the franchisor to deliver any specific form of disclosure document; however, the franchisor still will be subject to Maryland's antifraud provisions for false or misleading statements or omissions.[69]

In North Dakota, franchisors that want to franchise in the state may apply to the commissioner for a no-action letter. Based on the authors' informal conversation with the state examiner's office, a no-action letter may be granted by the North Dakota commissioner under some circumstances. The commissioner will take into consideration the length of time that the franchisor has been in business, the financial situation of the franchisor, the sophistication of the franchisee, and other relevant facts in making its determination.

In Rhode Island, an exemption from registration is available when it is not necessary or appropriate in the public interest or for the protection of prospective franchisees. Although Rhode Island's statute includes a disclosure requirement, in the authors' experience, Rhode Island will, under appropriate circumstances, grant an exemption from registration and disclosure.

Washington does not have a fractional franchise exemption. The state's current position is that franchisors must look to the other exemptions of the Washington statute. Washington does not grant discretionary exemptions and cannot waive the statutory provisions.

IF THE FRACTIONAL FRANCHISE FAILS

Under appropriate circumstances, there may be an argument that the arrangement is not a franchise at all: the FTC definition of a franchise requires that the franchisor provide control or assistance with respect to the franchisee's "entire method of operation," which arguably may mean that assistance must extend to all of the franchisee's business. The FTC Advisory Opinions do not appear to be consistent on this issue. One noted the confusion in the phrase *entire method of operation* and rejected the argument that *entire method of operation* means that a small portion of income derived from services through the franchisor would not be a franchise. Rather, the opinion noted that "[t]he relevant business is not what the franchisees will ultimately sell to the public but the business that is the subject of the relationship between the franchisor and the franchisee."[70] On the other hand, Informal Advisory Opinion 98-4 noted that

> . . . in order to be deemed "significant" the controls or assistance must be related to the franchisee's entire method of operation—not its method of selling a specific product or products which represent a small part of the franchisee's business. Controls or assistance directed to the sale of a specific product which have, at most, a marginal effect on a franchisee's method of operating the entire business will not be considered in determining whether control or assistance is "significant."
>
> Further, "significance" is a "function of the degree of reliance which franchisees are reasonably likely to place upon the controls or assistance." This is especially true of investors who are inexperienced in the particular business. The Commission addresses "significant control and assistance" issues on a case-by-case basis. Among other things, the Commission considers the nature of the particular industry, the level of sophistication of the investors, as well as the meaning of the assistance and control to the investors.[71]

That Advisory Opinion was cited with favor in a case involving the LeafGuard gutter system by the U.S. District Court for the District of South Carolina, which noted that the control and assistance element of the FTC Rule's franchise definition was not present in the LeafGuard arrangement.[72] The controls and assistance related to selling a specific product that dealt with the sale and installation of LeafGuard gutters, the court found, and was only one of multiple products and services sold by the putative franchisee. Although the putative franchisor did not raise the fractional franchise exemption as a defense, the court's reasoning might serve as a fallback argument for a franchisor facing a challenge with respect to whether the fractional franchise exemption applies to its business arrangement. However, it should be noted that the Informal Advisory Opinion relied upon by the court focused on the distinction between the degree and type of oversight and assistance a licenser may provide under a trademark license agreement on one hand and the degree and type of control provided in a franchise relationship on the other. In that context, the Informal Advisory Opinion explained that the assistance must relate to the entire method of operation of the franchised business, as opposed to the sale of a specific product or service.

FRANCHISE RELATIONSHIP LAWS AND LITTLE FTC ACTS

Even if a franchisor is exempt from the franchise registration and disclosure requirements of a franchise in a registration or nonregistration state, a fractional franchise might still be subject to various other relationship laws that deal with terminations, renewals of franchises, and other aspects of the franchise relationship. Most of the states with franchise disclosure laws have separate relationship laws, and the definition of a franchise or other types of relationships covered may differ considerably from the definition of a franchise under a state's disclosure law. Also, whether or not separate,

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the relationship laws may not provide the same exemptions as under the disclosure laws, so fractional franchises exempt from disclosure may not be exempt from the relationship laws. In addition, several states that do not regulate franchise disclosure regulate the ensuing franchise relationship. Some of these statutes apply very broadly, and fractional franchises may be subject to those statutes. One example of a very broad relationship statute is the Wisconsin Fair Dealership Law (WFDL).[73] The WFDL applies to dealership agreements and defines such agreements as those under which a person is granted the right to distribute goods or services or use a trademark or other commercial symbol and in which there is a "community of interest."[74] It mandates, among other requirements, that a manufacturer or franchisor have good cause for termination of an agreement that falls within the scope of the statute. *Community of interest* means "a financial interest between the grantor and grantee in either the operation of the dealership business or the marketing of such goods or services."[75] Wisconsin courts have developed elaborate tests for determining who constitutes a dealer,[76] but for purposes of the fractional franchise exemption, it is most important to note that a financial interest that satisfies the community of interest standard can be quite limited in relation to the dealer's total business. The Wisconsin Supreme Court has found that where as little as 8 percent or 9 percent of the dealer's total revenue came from the dealership agreement, the agreement may be subject to the WFDL.[77]

BUSINESS OPPORTUNITY LAWS

A fractional franchise may not necessarily be exempt from the disclosure and registration under business opportunity laws. Twenty-six states have "business opportunity" or "seller-assisted marketing plan" laws: Alaska, California, Connecticut, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia, Washington, and Wisconsin. Some of these laws have their own registration and disclosure requirements as well as financial assurance requirements; however, some do not have a filing requirement. The definition of a business opportunity or seller-assisted marketing plan is often broad enough to cover a fractional franchise. In most cases, however, there is an exemption if the purchaser is already in business and not starting a business.

Although a detailed analysis of business opportunity laws is beyond the scope of this article,[78] it is important to review these laws as well. State business opportunity laws may vary significantly, but generally they apply where a business opportunity seller agrees to provide or sell products, equipment, supplies, or services that will enable the business opportunity buyer to start or operate a business.[79] It is easy to see the overlap between franchise laws and business opportunity laws from that generalized definition, and most franchises would fall within the definition. Franchises are usually exempt from state business opportunity laws based on specific franchise exemptions to those statutes, or on exemptions that exempt any business opportunity through which the business opportunity buyer is licensed to use the seller's federally registered (or, in some instances, state-registered) trademark.

However, with respect to fractional franchises, two different aspects of the business opportunity statutes may be more relevant than for most other franchises. First, does a fractional franchise franchisee start a business within the meaning of the business opportunity laws? Second, if the business opportunity laws apply, can the franchise-specific exemptions to these laws be relied upon by an exempt franchise system?

Business opportunity states might interpret the notion of starting a business in different ways. However, one logically might expect that a fractional franchise that satisfies the two-year, same type of business element would be viewed as one that is not starting a business and, hence, would not be subject to business opportunity laws. However, it is unclear how each state would interpret the requirement. *Bunting v. Perdue, Inc.*,[80] a case involving interpretation of the North Carolina Business Opportunity Sales Act (NCBOSA), illustrates how difficult it can be to construe the starting a business requirement. Plaintiff had entered into its first agreement to act as an independent contract grower with Perdue before the enactment of the NCBOSA. Two years later, and after the enactment of the NCBOSA, it entered into a second agreement with Perdue. The second agreement required a second chicken house to be built. After Perdue terminated the agreements with plaintiff, plaintiff brought an action raising claims under the NCBOSA. Plaintiff alleged that the second agreement involved starting a new business and, therefore, that part of the relationship was within the scope of the statute. Perdue argued that plaintiff was not starting a new business but merely expanding an existing business. The court found for defendant, though without much reasoning.[81] The case also illustrated that a violation of a business opportunity law could arguably be a violation of the state's Little FTC Act.

A franchisor of a fractional franchise that is trying to navigate the state business opportunity laws also must be aware that some of the laws apply not only to buyers that are starting a business but also to ongoing businesses. This is the case, for example, in California,[82] Indiana,[83] and Nebraska.[84] In such states, a franchisor's argument that the franchisor is not providing products or services to help the franchisee start a business and therefore should be outside the scope of the business opportunity law would fail. The franchisor would have to rely on the franchise fitting within the general franchise exemption (or a similar exemption). Franchisors of fractional franchise systems will have to take care to review those business opportunity laws that may apply to their franchise sales to ensure that the franchise exemptions are broad enough to encompass a fractional franchise, especially in those states where fractional franchises may be excluded from the definition of a franchise under the state's

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franchise disclosure laws.

If a franchisor is required to register as a business opportunity for the fractional franchise business, it may elect not to sell in those states because the registration and disclosure requirements are cumbersome and often impose onerous requirements, such as posting a bond. Alternatively, it may go ahead and comply with the franchise laws and not rely on the fractional franchise exemption.

CONCLUSION

Under the right circumstances, the fractional franchise exemption can prove to be useful. However, practitioners and franchisors alike must recognize the exemption's limitations and risks and be wary of the land mines, such as different definitions and interpretations; the inability to use the exemption in some states; and the possible application of some business opportunity, franchise relationship, and antifraud laws. There are, of course, many times when a franchisor may be exempt from disclosure and registration requirements for one reason or another but nonetheless may decide to make disclosure, whether out of an abundance of caution; for the benefits that can be derived from providing a prospective purchaser with relevant information; or simply to avoid being hamstrung by the complexities, uncertainties, and limitations of the law.

Indeed, there is a place for the fractional franchise exemption. It can serve a real purpose and allow for faster expansion of certain businesses. Unfortunately, until the patchwork of state laws becomes consistent and interpretations of the exemption are more prevalent, those relying on the exemption must tread cautiously and may be forced to avoid expansion in certain states unless they comply with the FDD disclosure requirements and state registration requirements. Uniformity at the state and federal level and more practical guidance on how to satisfy the safe harbors would be welcome.

Those who seek to take advantage of the fractional franchise on a truly national scale without an FDD face the limitations of avoiding sales in at least some states if there is doubt as to the scope of the business or if there is a possibility that the new business could be viewed as more than just an add-on to the existing business. As a result, a franchisor that truly intends to expand in every state will likely need an FDD. Once an FDD is prepared, even if for just one state, prudence would generally dictate using it in all states. For a national program, the savings of the fractional franchise are elusive, and the time and effort spent screening prospects, trying to interpret the various state exemptions to determine if a prospect will satisfy the experience requirement, structuring the business in an effort to avoid business opportunity laws, and monitoring strict compliance programs will likely not be worth the trouble—at least not until all states adopt the same exemption; provide clearer guidance on the close questions about business experience; and provide more practical, realistic advice on how to make projections. For now, the fractional franchise should be limited to those local and regional businesses that are unquestionably ancillary and clearly will constitute less than 20 percent of total sales, and to those franchisors that are willing to sell only in states where the definition of a fractional franchise is easily satisfied.

ENDNOTES

1. The fractional franchise exemption is one of four exemptions provided by the FTC Rule. *See* 16 C.F.R. § 436.2(d) (2007). See Karen B. Satterlee & Leslie D. Curran, *Exemption-Based Franchising: Are You Playing in a Minefield?*, 28 Franchise L.J. (2009), for an overview of federal and state law exemptions.

2. Practitioners should be aware that Michigan requires franchisors that satisfy the fractional franchise exemption criteria nonetheless to register and disclose the prospective franchisee with an FDD if the franchisor has prepared an FDD for use in other states. Mich. Comp. Laws § 445.1506(2) (2010). It also should be noted that the New York fractional franchise exemption is an exemption from registration only. However, the disclosure obligation under the New York franchise law appears to apply only to franchises that are subject to a registration requirement. *See* N.Y. Gen. Bus. Law § 683(8) (McKinney 2010). To avoid any doubt, conservative franchisors may wish to request a discretionary exemption from both registration and disclosure.

3. 16 C.F.R. § 436.2(h), Bus. Franchise Guide (CCH) ¶ 6192 (1979).

4. 16 C.F.R. §§ 436.1 et seq., Bus. Franchise Guide (CCH) ¶ 6010 (2007).

5. 16 C.F.R. § 436.1(g), Bus. Franchise Guide (CCH) ¶ 6011 (2007).

6. FTC Informal Staff Advisory Op. 98-6, Bus. Franchise Guide (CCH) ¶ 6495 (Aug. 12, 1998).

7. FTC Informal Staff Advisory Op. 97-1, Bus. Franchise Guide (CCH) ¶ 6481 (Nov. 5, 1996).

8. FTC Informal Staff Advisory Op. 94-8, Bus. Franchise Guide (CCH) ¶ 6464 (Dec. 21, 1964).

9. *Id.*

10. *Id.*

11. FTC Informal Staff Advisory Op. 96-2, Bus. Franchise Guide (CCH) ¶ 6477 (May 20, 1996).

12. FTC Informal Staff Advisory Op. 99-5, Bus. Franchise Guide (CCH) ¶ 6502 (July 2, 1999).

13. 16 C.F.R. § 436.1(g), Bus. Franchise Guide (CCH) ¶ 6011 (2007).

14. FTC Informal Staff Advisory Op. 97-1, Bus. Franchise Guide (CCH) ¶ 6481 (Nov. 5, 1996).

15. FTC Informal Staff Advisory Op. 04-4, Bus. Franchise Guide (CCH) ¶ 6524 (Nov. 8, 2004).

16. FTC Informal Staff Advisory Op. 94-4, Bus. Franchise Guide (CCH) ¶ 6460 (May 12, 1994).

17. 16 C.F.R. § 436.1(h), Bus. Franchise Guide (CCH) ¶ 6010 (2007).

18. *Id.* §§ 436 et seq.

19. *Id.* § 436.1(h). The authors have found no guidance in case law or interpretive sources to the FTC Rule regarding what is meant by *first year of operation*. Most likely, the drafters intended the common understanding of the word *operation*, thus excluding the period

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of time from when the franchise agreement was signed until the build-out is complete. However, this is a question that remains to be answered.

20. Note that the second element of the fractional franchise definition requires both parties to have a reasonable basis for their revenue estimate. However, in practice, there are limited consequences to the franchisee that did not do its due diligence in this regard.

21. The experience required for the fractional franchise exemption differs significantly from that permitted under the exemption for a sophisticated investor. In the latter case, experience in any other business whatsoever is acceptable. *See* FTC Informal Advisory Op. 97-1, Bus. Franchise Guide (CCH) ¶ 6481 (Nov. 5, 1996).

22. Statement of Basis and Purpose for the Amended FTC Rule, 72 Fed. Reg. 15,444, 15,458, Bus. Franchise Guide (CCH) ¶ 6060 (Mar. 30, 2007) (noting that prior experience in any economic sector does not necessarily mean that the franchisee would have sufficient experience to operate a different franchise within the same sector).

23. Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,965, 49,968 (Aug. 24, 1979); *see also* Statement of Basis and Purpose, 43 Fed. Reg. 59,614, 59,706–07 (Dec. 21, 1978). The fractional franchise exemption is not limited to the sale of goods but applies to services as well. FTC Informal Staff Advisory Op. 93-5, Bus. Franchise Guide (CCH) ¶ 16,449 (Apr. 2, 1993) (noting that the Statement of Basis and Purpose accompanying the FTC Rule states that "if the prospective franchisee is currently selling the type of goods or services which he will distribute under the new franchise[,] . . . he will be 'in the business represented by the franchise.'" Statement of Basis and Purpose, 43 Fed. Reg. at 59,706, n.80). Thus, if the prospective franchisee is currently selling the type of goods or services that it will distribute under the new franchise (*see* Statement of Basis and Purpose, 43 Fed. Reg. at 59,706) or if the prospective franchisee is in a business that ordinarily would be expected to sell that type of goods and services, it will be "in the business represented by the franchise." Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. at 49,968.

24. Statement of Basis and Purpose, 43 Fed. Reg. at 59,706–07.

25. Statement of Basis and Purpose for the Amended FTC Rule, 72 Fed. Reg. at 15,458. Another example used by the FTC is the fast-food kiosk operator that acquires a large, sit-down, full-service restaurant. The two businesses are both in the food industry but would not be considered "the same business."

26. FTC Compliance Guide, Bus. Franchise Guide (CCH) ¶ 6082.

27. Statement of Basis and Purpose for the Amended FTC Rule, 72 Fed. Reg. at 15,459.

28. FTC Informal Staff Advisory Op. 95-10, Bus. Franchise Guide (CCH) ¶ 6475 (Dec. 8, 1995).

29. FTC Informal Staff Advisory Op. 94-8, Bus. Franchise Guide (CCH) ¶ 6464 (Dec. 21, 1964).

30. *Id.*

31. FTC Informal Staff Advisory Op. 96-2, Bus. Franchise Guide (CCH) ¶ 6477 (May 20, 1996).

32. *Id.*

33. *Id.*

34. FTC Informal Staff Advisory Op. 99-5, Bus. Franchise Guide (CCH) ¶ 6502 (July 2, 1999).

35. *Id.*

36. *Id.*

37. As discussed below, it is not clear whether state fractional franchise exemptions would permit substituting the franchisee's own experience for that of an affiliate.

38. This is assuming that the franchisee has sufficient other business for the parties to be able to estimate in good faith that the hotel will not account for more than 20 percent of the franchisee's revenue in its first year of operation. An individual from management also would have to hold an appropriate position with the franchisee to satisfy the experience requirement. In a few states, such as California and New York, the use of a management company would not be possible because those states require that a person's experience be acquired while with the franchisee.

39. Interpretive Guides to 1979 Franchising and Business Opportunity Ventures Trade Regulation Rule, Bus. Franchise Guide (CCH) ¶ 6210 (1979).

40. FTC Informal Staff Advisory Op. 99-5, Bus. Franchise Guide (CCH) ¶ 6502 (July 2, 1999).

41. Rupert M. Barkoff, Brian B. Schnell & W. Andrew Scott, *How to Prepare, Read, and Use a Financial Performance Representation*, *in* FINANCIAL PERFORMANCE REPRESENTATIONS 69, 83 (Stuart Hershman & Joyce Mazero eds., 2008).

42. FTC Compliance Guide, Bus. Franchise Guide (CCH) ¶ 6082.

43. FTC Informal Staff Advisory Op. 96-2, Bus. Franchise Guide (CCH) ¶ 6477 (May 20, 1996).

44. *Id.*

45. FTC Informal Staff Advisory Op. 99-5, Bus. Franchise Guide (CCH) ¶ 6502 (July 2, 1999).

46. FTC Informal Staff Advisory Op. 97-1, Bus. Franchise Guide (CCH) ¶ 6481 (Nov. 5, 1996).

47. *Id.*

48. FTC Informal Staff Advisory Op. 99-5.

49. FTC Informal Staff Advisory Op. 98-6, Bus. Franchise Guide (CCH) ¶ 6495 (Aug. 12, 1998).

50. *Id.*

51. FTC Informal Staff Advisory Op., Real America Real Estate Corp., Bus. Franchise Guide (CCH) ¶ 6428 (Apr. 9, 1982).

52. 16 C.F.R. § 436.10(b) (2007).

53. This is assuming that no other exemptions are available.

54. The Oregon state statute only requires disclosure, consistent with the Amended FTC Rule. It does not require registration with the state.

55. CAL. CORP. CODE § 31110; HAW. REV. STAT. § 482E-3; 815 ILL. COMP. STAT. ANN. 705/10 (West 2010); IND. CODE § 23-2-2.5-10.5; MD. CODE ANN., BUS. REG. § 14-214 (2010); MICH. COMP. LAWS ANN. § 445.1507a (West 2010); MINN. STAT. ANN. § 80C.02 (West 2010); N.Y. GEN. BUS. LAW § 683; N.D. CENT. CODE § 51-19-03; OR. REV. STAT. § 650.010; R.I. GEN. LAWS § 19-28.1-5; S.D. CODIFIED LAWS § 37-5B-4; VA. CODE ANN. § 13.1-560 (Michie 2010); WASH. REV. CODE § 19.100.020; WIS. STAT. § 553.21.

56. Depending on the exemption applied for, disclosure using an FDD may be required.

57. 815 ILL. COMP. STAT. ANN. 705/3; IND. CODE § 23-2-2.5-1; VA. CODE § 13.1-559.

58. CAL. CIV. CODE § 31108 (West 2010).

59. 815 ILL. COMP. STAT. ANN. 705/3.

60. MICH. COMP. LAWS ANN. § 445.1506(h).

61. MINN. STAT. ANN. § 80C.1(18) (West 2010).

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62. Va. Code Ann. § 13.1-559 (Michie 2010).

63. N.Y. Comp. Codes R. & Regs. § 200.10; Mich. Comp. Laws § 445.1506(h).

64. Va. Code Ann. §13.1-559.

65. Mich. Comp. Laws § 445.1506.

66. *Id.*

67. Md. Code Regs. § 02.02.08.10 (2010).

68 *Id.* § 02.02.08.10(G)(1)(a)–(b).

69. Md. Code Ann., Bus. Reg. § 14-230 (2010).

70. FTC Informal Staff Advisory Op. 97-7, Bus. Franchise Guide (CCH) ¶ 6487 (Aug. 18, 1997). Note that based on the specific language of state law definitions of a franchise, it may be possible to argue that even without the availability of a fractional arrangement, an arrangement is not subject to franchise and disclosure laws. The author of the *Franchise Law Desk Book* on the Washington law surmised that, as modified in 1991, the Washington Act "now requires proof that the franchisee's 'business is substantially associated with' a trademark or service mark licensed by the franchisor. Though there are no cases construing this requirement, it presumably means at the very least that a fractional franchise as defined by the FTC Rule would not satisfy the trademark element." Note that there is no assurance that the Washington administrator or a court would agree with this interpretation. W. Michael Garner, Franchise Law Desk Book, 2nd Edition: Selected State Laws, Commentary and Case Annotations 787 (2001).

71. FTC Informal Staff Advisory Op. 98-4, Bus. Franchise Guide (CCH) ¶ 6493 (June 8, 1998) (citing 44 Fed. Reg. 49,965, 49,967 (Aug. 24, 1979); Statement of Basis and Purpose, 43 Fed. Reg. 59,614, 59,701 (Dec. 21, 1978)).

72 Englert, Inc. v. LeafGuard USA, Inc., 2009 WL 5031309, Bus. Franchise Guide (CCH) ¶ 14,297 (D.S.C. Dec. 14, 2009).

73. Wis. Stat. Ann. §§ 135.01 et seq. (West 2010).

74. *Id.* § 135.02 (3)(a).

75. *Id.* § 135.02 (1).

76. *See* Brio Corp. v. Meccano S.N., 690 F. Supp. 2d 731 (E.D. Wis. 2010).

77. Cent. Corp. v. Research Prods. Corp., 681 N.W.2d 178, 189 (Wis. 2004).

78. See James A. Meaney & John R. F. Baer, *The Business Opportunity Laws: An Enforcement and Litigation Trap?*, ABA Annual Forum on Franchising (2001), for an extensive analysis of state business opportunity laws. Since that article was written, Alaska also has adopted a business opportunity law.

79. Meaney & Baer, *supra* note 78, at 6.

80. 611 F. Supp. 682, Bus. Franchise Guide (CCH) ¶ 8674 (E.D.N.C. 1985).

81. *Id.*

82. Cal. Civ. Code § 1812.201(a), Bus. Franchise Guide (CCH) ¶ 3058.2 (2010).

83. Ind. Code § 24-5-8-1, Bus. Franchise Guide (CCH) ¶ 3148.01 (2010).

84. Neb. Rev. Stat. § 59-1703, Bus. Franchise Guide (CCH) ¶ 3278.03 (2010).

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