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**FROM LICENSE AGREEMENT TO REGULATED
RELATIONSHIPS: THE ACCIDENTAL FRANCHISE**

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I. INTRODUCTION

As the old adage goes, “If it walks like a duck and quacks like a duck, it is a duck,” the same holds true in franchise law if a business relationship meets the three-prong test for a franchise. Regardless of what the parties call the relationship, it is a franchise. The temptation of avoiding franchise laws seems to be as prevalent among business owners as their desire to franchise their business. With franchise laws on the books at the federal level, and, in many states at the state level, avoiding the laws and rules that exist is no easy matter. This paper will explore the various laws that would-be franchisors need to be aware of at different stages of their franchise relationship such as state and federal disclosure laws, state relationship laws, as well as industry specific franchise laws and business opportunity laws. It will look at alternative distribution models that are similar to franchising and look at the potential pitfalls of those models. It will also explore the consequences of non-compliance.

II. DEFINITION—KEY ELEMENTS UNDER DIFFERENT STATUTES

A. Franchise Laws - The Elements of a Franchise

1. The Amended FTC Rule

In 1971, the Federal Trade Commission (“FTC”) initiated a rule-making procedure in order to combat rampant fraud that was occurring in the 1950s and 1960s by some “fly-by-night” franchisors.¹ As a result, the “Original” FTC Rule became effective in 1979.² The Original FTC Rule covered both “franchises” and “business opportunities.”³ In 1995, the FTC began regulatory review of the Original FTC Rule, and, as a result, the “Amended” FTC Rule became effective July 1, 2007. Franchisors were required to comply with the Amended FTC Rule by no later than July 1, 2008.

The Amended FTC Rule focuses exclusively on franchises, and the portions of the Original FTC Rule relating to business opportunities have been split into a separate FTC Rule applicable only to business opportunities.⁴ While there is no uniform definition of “franchise,” the Amended FTC Rule’s definition, which remained largely the same as the definition included in the Original FTC Rule, is consistent with the principles underlying the states’ various definitions of “franchise.”⁵ However, the new definition of “franchise” did affirm case law on two concepts: (1) regardless of the names or labels used, if a relationship meets the required elements, it constitutes a franchise; and (2) if the franchisor represents that the relationship being offered has the characteristics of a franchise, the relationship constitutes a franchise, even if the franchisor never performs as represented.

¹ DAVID J. KAUFMANN AND DAVID W. OPPENHEIM, FTC DISCLOSURE RULES FOR FRANCHISING AND BUSINESS OPPORTUNITIES 11 (Wolters Kluwer Law & Business 2007).

² 16 C.F.R. § 436 (1979).

³ 16 C.F.R. § 436 (2007) (replaced by the amended FTC Rule on July 1, 2007 (the “Amended FTC Rule”) with continued use of the “Original” FTC Rule permitted until July 1, 2008).

⁴ 16 C.F.R. Part 436 (2007). Business opportunities are now governed by their own rule essentially containing the same provisions as the Original FTC Rule, 16 C.F.R. Part 437 (2007) - Disclosure Requirements and Prohibitions Concerning Business Opportunities.

⁵ The Statement of Basis and Purpose for the Amended FTC Rule, 72 Fed. Reg. 61, 15444-15492 (March 30, 2007), Bus. Franchise Guide (CCH) ¶ 6050.

Specifically, under the Amended FTC Rule, a “franchise” is defined as:

any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:

- (1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;
- (2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and
- (3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.⁶

2. The Definition of Franchise under State Laws

State franchise acts' various definitions of “franchise” are similar to the definition in the Amended FTC Rule, with a slight variation of the second element (the control/marketing plan element). While the Amended FTC Rule speaks of the authority of the franchisor to exert control or provide significant assistance over the franchisee's method of operation, state franchise statutes generally either contain a “marketing plan” requirement or, alternatively, a “community of interest” requirement.

3. The Elements of a “Franchise” under Federal and State Law

a. Trademark Association

Both the Amended FTC Rule and state franchise laws require that the franchisee has the right to associate with the franchisor's trademarks. However, the extent to which the franchisee must be granted the right to “associate” with the franchisor's trademarks varies from state to state. In general, however, there are two approaches to meeting this element: (1) some state statutes require that the franchisee be granted a license to utilize the franchisor's trademarks; or (2) other states simply require that the franchisee be substantially associated with the franchisor's trademarks.

The License Approach

A minority of franchise acts use the “license approach” to the trademark requirement. A contractual grant of the right to use the putative franchisor's trade name or marks is sufficient to meet the trademark requirement under the license approach. The grant of the right to use a trade name need not be express.⁷ Additionally, some courts do not require that the franchisor grant the franchisee the right to hold itself out as doing business under the franchisor's name. For example, under Minnesota law, the only requirement is that the franchisor allows the

⁶ The Amended FTC Rule, 16 C.F.R. § 436.1(h) (2007).

⁷ *Unlimited Horizon Mktg., Inc. v. Precision Hub, Inc.*, 533 N.W.2d 63, 66-67; Bus. Franchise Guide (CCH) ¶ 10,717 (Minn. Ct. App. 1995).

franchisee to use the franchisor's name in some way, including, for example the use of advertising that contains the franchisor's trade name.⁸

The Substantial Association Approach

The FTC Rule requires that the franchisee has the right to operate a business that is "identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark."⁹

As used under the FTC Rule, the term "trademark" is intended to have a broad definition and includes not only trademarks, but any service mark, trade name or other advertising or commercial symbol.¹⁰ The FTC Rule does not require that the franchisor actually own the mark, so long as the franchisor has the right to license others to use the mark.¹¹ According to the Franchise Rule Compliance Guide, if a supplier wants to avoid compliance with the FTC Rule, the supplier can do so by expressly prohibiting the distributor from using the supplier's trademark.¹² However, a supplier could fall within the coverage of the FTC Rule if the supplier prohibits use of the trademarks in the written agreement but, in fact, allows the distributor to use the supplier's marks or fails to enforce the contractual prohibition against use of the supplier's marks.

The requirement under some state statutes' that there be substantial association with the franchisor's trademarks have been more stringently interpreted than under other state statutes. For example, the substantial association approach, generally, does not mean that the putative franchisee has to carry exclusively franchisor-trademarked products, but "a showing of a dependence on the public's confidence in the franchised product for most or all of the franchisee's business is required."¹³ However, courts have not ruled consistently on the degree of association that is required. For example, one case interpreting the Connecticut Franchise Act interpreted such language more strictly, requiring the putative franchisee to demonstrate that its business is "nearly exclusively associated with the trademark."¹⁴ Yet, interpreting the same Act, the Connecticut District Court made a provisional finding that a putative franchisee met the substantially associated requirement where the franchisor's products accounted for only 23-27% of the franchisee's business, but where the franchisee engaged in advertising linking the franchisee with the franchisor's products, used the franchisor's trade name on business cards and delivery trucks, and the phone answering system automatically directed callers to push a button on their phone if they wanted to hear more information about the franchisor's product.¹⁵

⁸ *RJM Sales & Mktg., Inc. v. Banfi Products Corp.*, 546 F. Supp. 1368, 1373; Bus. Franchise Guide (CCH) ¶ 7905 (D. Minn. 1982).

⁹ The Amended FTC Rule, 16 C.F.R. § 436.1(h) (2007).

¹⁰ Federal Trade Commission, *Franchise Rule Compliance Guide*, at p. 2, available at <http://www.ftc.gov/bcp/edu/pubs/business/franchise/bus70.pdf> (last visited July 11, 2009).

¹¹ *Id.*

¹² *Id.*

¹³ *B & E Juices, Inc. v. Energy Brands, Inc.*, No. 3:07CV1321 (MRK)(WIG), 2007 WL 3124904 at *12 (D. Conn. Oct. 25, 2007).

¹⁴ *Terex Corp. v. Cubex, Ltd.*, Bus. Franchise Guide (CCH) ¶ 13,498; 2006 WL 3542706 at *8 (N.D. Tex. Dec. 7, 2006) (holding that because Cubex goods only accounted for 0.125 percent of total sales, Terex was far from meeting the substantial association requirement).

¹⁵ *Spear-Newman, Inc. v. E.I. Du Pont de Nemours & Co.*, No. 3:91CV00652WWE, 1991 WL 318725 (D. Conn. Jan. 17, 1991).

Illinois defines more specifically what it means by the term “substantially associated” in the state regulations. As provided by the Illinois Regulations, a franchisee’s business is substantially associated with the franchisor’s trademark or other marks within the meaning of the Illinois Franchise Disclosure Act, “if the franchise or other agreement, the nature of the franchise business or other circumstances permit or require the franchisee to identify its business to its customers primarily under such trademark . . . or to otherwise use the franchisor’s mark in a manner likely to convey to the public that it is an outlet of the franchisor.”¹⁶ Furthermore, the Illinois Regulations explicitly state that an absence or silence in the franchise agreement of a grant to use the franchisor’s name or mark, in and of itself, is not enough to avoid the trademark requirement.¹⁷ Even if there is a contractual prohibition on the use of the franchisor’s name or mark; the contractual prohibition must also actually be policed and enforced to insure that the name or mark is not being substantially used without the franchisor’s knowledge.¹⁸

There is at least one case that has stretched the trademark element quite far. In *Kim vs. Servosnax*,¹⁹ the franchisee was not granted the right to use, and in fact did not use, a trademark belonging to the putative franchisor and the public never saw one. In that case, the putative franchisor was in the business of developing employee cafeterias and then licensing the completed cafeteria to a licensee who was prohibited from using the developer’s name in the operation of the cafeteria. The court found that the licensed business was nevertheless substantially associated with the developer’s trademark or commercial symbol within the “franchise” definition of the California Franchise Investment Law because the host company in whose building the cafeteria was located had relied on the developer’s name, goodwill and reputation in granting the right to develop the cafeteria, and that association was sufficient to satisfy the trademark element.

b. Significant Control or Assistance Concerning Franchisees Method of Operation, Marketing Plan or Community of Interest

i. Significant Control or Assistance

The Amended FTC Rule requires that the franchisor “exert or has the authority to exert a significant degree of control over the franchisee’s method of operation, or provide significant assistance in the franchisee’s method of operation.”

Significant types of control include:

- site approval for unestablished businesses;
- site design or appearance requirements;
- control over hours of operation;
- control over production techniques;
- control over accounting practices;

¹⁶ Ill. Admin. Code tit. 14, § 200.103.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ 10 Cal. App. 4th 1346, 1355-57 (Cal. Ct. App. 1992).

- control over personnel policies;
- promotional campaigns requiring franchisee participation or financial contribution;
- restrictions on customers; and
- approval of locale or area of operation.²⁰

Significant types of assistance include:

- formal sales, repair, or business training programs;
- establishing accounting systems;
- furnishing management, marketing, or personnel advice;
- selecting site locations;
- furnishing systemwide networks and website; and
- furnishing a detailed operating manual.²¹

In *United States v. Protocol, Inc.*, the court held that a vending machine manufacturer provided “significant assistance” to its distributors within the meaning of the FTC Rule by providing extensive marketing and sales advice, including, among other things, a marketing manual, sales training, sales support literature, ongoing support and customer service, and an accounts program.²²

Unless accompanied by additional forms of assistance or control, in general, the following do not constitute “significant” control or assistance:

- promotional activities intended to help the distributor in making sales;
- trademark controls designed solely to protect the trademark owner’s legal ownership rights to the mark;
- health or safety restrictions required by the law; or
- aiding the distributors in obtaining financing to be able to conduct business.²³

Unlike in the *Protocol* case, in *FTC v. Communidyne*, a breathalyzer manufacturer provided its distributors with promotional materials representing that it would assist its distributors with financing, technical support, training materials and instructions on how to promote the breathalyzers. The court held that the representations did not constitute significant assistance

²⁰ See *supra* note 10, at 2-4.

²¹ See *supra* note 10, at 2-4.

²² Bus. Franchise Guide (CCH) ¶ 11,184 (D. Minn. May 21, 1997).

²³ See *supra* note 10, at 4.

within the meaning of the FTC Rule because, at most, the representations were simply “offers” to provide assistance rather than “promises.” Furthermore, the court held that, even if the representations could be construed to be “promises,” the substance of the promises tended to fall within the “promotional activities” safe harbor.²⁴

ii. Marketing Plan/Community of Interest

Marketing Plan

Depending on the state statute, the second element that a putative franchisee must meet is the marketing plan or community of interest requirement—trying to define these terms is equally elusive.

Under the marketing plan requirement, the franchisee must be granted the right to offer, sell or distribute goods or services, under a *marketing plan or system prescribed* (or, sometimes, *suggested*) *in substantial part by the franchisor*. California, Illinois, Indiana, Maryland, Michigan, New York, North Dakota, Oregon, South Dakota, Rhode Island, Virginia, Washington, and Wisconsin²⁵ follow the marketing plan approach.²⁶

Whether a marketing plan exists turns largely on the amount of control that the franchisor exercises over the franchisee’s business. Some factors a court might consider to determine if there is a marketing plan include whether the franchisor: (1) requires a marketing plan; (2) has power over franchisee pricing; (3) has power over hiring and firing the franchisee’s personnel; (4) has power to require training of the franchisee’s personnel; and (5) has power to examine franchisee’s financial records.²⁷ The franchisor’s power over pricing is a key factor that is indicative of a marketing plan.²⁸ However, a franchisor’s lack of power over pricing does not mean that the marketing plan requirement cannot otherwise be met.

Additionally, some courts have determined that a marketing plan exists even when participation in the marketing plan is optional.²⁹ A marketing plan may be prescribed by implication. Under the California Franchise Investment Law, a marketing plan is prescribed by implication where “the franchisor supplies the franchisee with sales aids or props, such as demonstration kits, films, or detailed instructions for personal introduction and presentation of the product, possibly including the text of a sales pitch and especially where such a program is supported by training material, courses, or seminars.”³⁰

²⁴ Bus. Franchise Guide (CCH) ¶ 10,465 (E.D. Ill. April 21, 1994).

²⁵ Wisconsin has both a disclosure and relationship act that governs franchises. Wisconsin’s disclosure act, the Wisconsin Franchise Investment Law, Wisconsin Statutes Section 553.01 et seq., has a marketing plan requirement, while the relationship act, Wisconsin Statutes Section 135.01 et seq., (which does not require a franchise fee) follows the community of interest requirement rather than the marketing plan requirement.

²⁶ Cal. Corp. Code § 31005(a)(2); 815 Ill. Comp. Stat. 705/3(1)(a); Ind. Code Ann. § 23-2-2.5-1(a)(1); Md. Code, Bus. Reg. § 14-201(e)(1)(i); Mich. Comp. L. § 445.1502(3)(a); N.Y. Gen. Bus. Law § 681(3)(a); N.D. Cent. Code § 51-19-02(5)(a)(1); S.D. Codified Laws § 37-5B-1 (closing following the FTC’s “substantial control” requirement); Or. Rev. Stat. § 650.005(4)(a); R.I. Gen. Laws § 19-28.1-3(7)(i)(A); Va. Code § 13.1-559 (A)(1); R.C.W. § 19.100.010(4)(a)(i); Wis. Stat. Ann. § 553.03(4)(a)(1) (West 2009).

²⁷ *Hartford Electric Supply Co. v. Allen-Bradley Co., Inc.*, 736 A.2d 824 (Conn. 1999).

²⁸ *Id.*

²⁹ *Blakenship v. Dialist Int’l Corp.*, 568 N.E.2d 503, 506-507 (Ill. App. Ct. 1991).

³⁰ Commissioner of Corporations Release 3-F Revised, June 22, 1994, *When Does an Agreement Constitute a “Franchise”?* reprinted at Bus. Franchise Guide (CCH) ¶ 5050.45.

In *Boats & Motor Mart v. Sea Ray Boats, Inc.*³¹, the Ninth Circuit analyzed whether a boat dealership was “granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor,” thereby meeting one of the three requirements for protection under the California Franchise Relations Act, Cal. Bus. & Prof. Code § 20001. The court began its analysis by stating that “a mere promise to sell aggressively ... [is] too vague to constitute a marketing plan....”³² The court went on, however, to find that requiring the plaintiff to engage in “aggressive advertising,” “conduct a variety of promotions and to carry [the defendant’s] array of accessory sales devices,” and the fact that the plaintiff received its “instructions and its basic sales information” from the defendant were more than enough to support a finding that the plaintiff followed a “marketing plan or system prescribed in substantial part by a franchisor.”³³

Illinois specifically defines “marketing plan or system” within its statute and corresponding regulations. Under the Illinois definition, the focus is on such factors as: (1) specification of price; (2) use of particular sales or display equipment; (3) specific sales techniques; and (4) use of advertising or promotional materials or cooperation in advertising efforts.³⁴

Community of Interest

Hawaii, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, South Dakota, and Wisconsin follow the community of interest requirement.³⁵ The Wisconsin Fair Dealership Law (“WFDL”) contains the community-of-interest requirement. In order to determine whether there is a community of interest for purposes of the WFDL, two general guidelines are used, including: that the grantor and dealer must possess a continuing financial interest in their business relationship and there must be an interdependence of the grantor and dealer, which requires “a likeness or similarity of interest” in the common business of the dealer and the grantor.³⁶ In order for there to be a continuing financial interest and interdependence, generally, a person is required to demonstrate a large enough stake to make the grantor’s power to terminate, cancel or not renew a threat to the economic health of the person—*i.e.*, that the grantor’s threatened action would have a significant economic impact on the dealer.³⁷

In *Moe v. Benelli*, the Wisconsin Court of Appeals overturned the circuit court’s summary judgment determination that a hardware store owner, who sold Benelli guns and accessories at

³¹ 825 F.2d 1285 (9th Cir. 1987).

³² *Id.* at 1289.

³³ *Id.*

³⁴ 815 Ill. Comp. Stat. § 705/3 (18) (2008).

³⁵ Haw. Rev. Stat. Ann. § 482E-2; Minn. Stat. § 80C.01, subd. 4(a)(1)(ii); Miss. Code § 75-24-51(6); Mo. Stat. § 407.400(1); Neb. Rev. Stat. § 87-402(1)(a); N.J. Stat. Ann. § 56:10-3(a); Wis. Stat. Ann. § 135.02(1).

³⁶ In analyzing whether there is a continuing financial interest and interdependence between the parties, the courts in Wisconsin use a ten-factor analysis, including: (i) how long the parties have dealt with each other; (ii) the extent and nature of the obligations imposed on the parties in the contract or agreement between them; (iii) what percentage of time or revenue the alleged dealer devotes to the alleged grantor’s products or services; (iv) what percentage of the gross proceeds or profits of the alleged dealer derives from the alleged grantor’s products or services; (v) the extent and nature of the alleged grantor’s grant of territory to the alleged dealer; (vi) the extent and nature of the alleged dealer’s uses of the alleged grantor’s proprietary marks (such as trademarks or logos); (vii) the extent and nature of the alleged dealer’s financial investment in inventory, facilities, and goodwill of the alleged dealership; (viii) the personnel which the alleged dealer devotes to the alleged dealership; (ix) how much the alleged dealer spends on advertising or promotional expenditures for the alleged grantor’s products or services; and (x) the extent and nature of any supplementary services provided by the alleged dealer to consumers of the alleged grantor’s products or services and *Ziegler Co. v. Rexnord, Inc.*, 139 Wis. 2d 593, 606, 407 N.W.2d 873, 879-80, Bus. Franchise Guide (CCH) ¶ 8882 (1987), *on recons.*, 147 Wis. 2d 308, 433 N.W.2d 8, Bus. Franchise Guide (CCH) ¶ 9317 (1988).

³⁷ *Moe v. Benelli U.S.A. Corp.*, 743 N.W.2d 691, 697 (Wis. Ct. App. 2007).

its store, was a “dealership” within the meaning of the WFDL.³⁸ The Court of Appeals refused to find the requisite community of interest where only 4.7% of the store's overall revenue in goods sold was from Benelli products, only 400 of the hardware store's 9,500 square feet was dedicated to Benelli products, and the fact that the store's gross sales increased by 6.5% the year after it stopped carrying Benelli products.³⁹

In contrast to Wisconsin, Minnesota courts have held that there is a community of interest when the parties shared fees from a common source.⁴⁰ In *Martin Investors, Inc. v. Vander Bie*, the Minnesota Supreme Court concluded that a community of interest existed where the franchisor was contractually entitled to a 1% share of the franchisee's sales.⁴¹

c. Fees

The Amended FTC Rule and most state franchise acts include a fee or required payment element that must be satisfied in order for a relationship to constitute a franchise. Generally, a franchise fee is considered any payment for the right to do business as a franchisee. For example, the Amended FTC Rule states the fee element as follows: “as a condition of obtaining or commencing operation of a franchise, the franchisee makes a required payment to the franchisor or its affiliate” and goes on to define a “required payment” as “all consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise.”⁴² Similarly, the California Franchise Investment Act states the fee element as the requirement to pay, directly or indirectly, a franchise fee and defines a franchise fee as “any fee or charge that a franchisee or subfranchisor is required to pay or agrees to pay for the right to enter into a business under a franchise agreement, including, but not limited to, any payment for goods and services.”⁴³

As is evident from the language in the above examples, the fee element is expansive and includes everything from contractually-required direct payments to the franchisor to payments to a franchisor's affiliate based on practical necessity. Further, the fee element has been interpreted in state and federal courts to include so-called “hidden” franchise fees that on their face may not look like traditional franchise fees. These hidden fees may include royalty payments,⁴⁴ equipment purchases,⁴⁵ inventory purchases,⁴⁶ marketing and promotional materials,⁴⁷ training fees,⁴⁸ and rent payments paid on behalf of a franchisor.⁴⁹

³⁸ *Id.*

³⁹ *Id.* at 698-700.

⁴⁰ *Martin Investors, Inc. v. Vander Bie*, 269 N.W.2d 868, 872 (Minn. 1978).

⁴¹ *Id.* at 874.

⁴² The Amended FTC Rule, 16 C.F.R. § 436.1(h)(3) (2007).

⁴³ Cal. Corp. Code §31011 (West 2006), Bus. Franchise Guide (CCH) ¶ 3050.13.

⁴⁴ *Intermark, Ltd. v. H.B. Smith Co., Inc.* (W.D. Wash 1990), Bus. Franchise Guide (CCH) ¶ 9660 (royalties paid by a sublicensee constituted a “franchise fee” under the Washington Franchise Investment Protection Act).

⁴⁵ *DataCard Corp. v. Secure Data Systems, Inc.* (D.C. Minn. 1993), Bus. Franchise Guide (CCH) ¶ 10,154 (excess paid above fair market value for a Mexican distributorship could be considered a “franchise fee” under the Minnesota Franchise Act).

⁴⁶ *Am. Parts Sys., Inc. v. T & T Automotive, Inc.*, 358 N.W.2d 674 (Minn. Ct. App. 1984) (minimum inventory purchase requirement could constitute a franchise fee under Minnesota law, even if the inventory was purchased at fair prices, when the quantity exceeded the reasonable requirements of the business).

⁴⁷ *Boat & Motor Mart v. Sea Ray Boats, Inc.*, 825 F.2d 1285 (9th Cir. 1987) (extensive advertising required by the dealership agreement constituted indirect payments of fees for the manufacturer's benefit).

On the other hand, courts recognize that the broad statutory fee definitions potentially encompass payments that were never intended to be considered “franchise fees” and generally construe the definition of franchise fees to apply to fees that are, at a minimum: (i) required (rather than optional), and (ii) made for the right to enter into the business. For example, in 2006 a California appellate court upheld a ruling that certain payments made by a U-Haul dealer plaintiff for a monthly telephone line and directory listings and other incidental expenses did not constitute franchise fees because the plaintiff had made no payments to U-Haul at the timing of entering into the contract and because the fees were not “required as a condition to becoming” a U-Haul Dealer.⁵⁰ The majority of courts have also generally held that fees paid to third parties (rather than the franchisor or an affiliate) do not constitute franchise fees.⁵¹

There are also definitional limitations that limit what payments constitute “franchise fees.” First, the Amended FTC Rule includes a minimum payment exemption, which excludes relationships that would otherwise be franchises if “the total of the required payments...to the franchisor or an affiliate that are made any time from before to within six months after commencing operation of the franchisee’s business is less than \$500.”⁵² Thus, one way to structure a transaction to avoid the federal franchise definition is to defer any payments for six months.⁵³ Some states, including California and New York, also permit up to \$500 (or some lesser amount) in fees to be paid annually without finding a “franchise fee.”⁵⁴ Illinois has a similar, but stricter, standard—if a franchisee is required to pay less than \$500 to the franchisor or its affiliates *over the entire life of the arrangement*, the fee element is not satisfied.⁵⁵ These

(Cont’d)

⁴⁸ *Metro All Snax, Inc., David Uglem, and Keirstin Uglem v. All Snax, Inc.*, (D.C. Minn. 1996), Bus. Franchise Guide ¶ 10,885 (snack distributor’s payment of \$34,500 for training and assistance provided in building up its distribution network constituted a franchise fee for purposes of the Minnesota disclosure/registration law).

⁴⁹ An interpretive opinion from the California Commissioner of Corporations (which regulates franchising in California) has indicated that if a franchisor leases real estate from a third party and then subleases the real estate to the franchisee, with the franchisee paying rent directly to the prime landlord, the rent paid by the franchisee to the third-party landlord can be considered paid “on behalf of” the franchisor and therefore count as a franchise fee. See “When Does an Agreement Constitute a ‘Franchise?’” Release 3-F from the California Commissioner of Corporations, reprinted at Bus. Franchise Guide (CCH) ¶ 5050.45 (June 22, 1996).

⁵⁰ *Thueson v. U-Haul Int’l, Inc.*, 50 Cal. Rptr.3d 669 (Cal. Ct. App. 2006), Bus. Franchise Guide (CCH) ¶ 13,459.

⁵¹ See, e.g., *RJM Sales & Mktg., Inc. v. Banfi Prod. Corp.*, 546 F. Supp. 1368 (D.C. Minn. 1982) (wine broker’s payments to outside firms for advertising materials did not constitute a franchise fee within the meaning of the Minnesota Franchise Law—the payments were ordinary business expenses); and *Kempner Mobile Elec., Inc. v. Southwestern Bell Mobile Sys., LLC*, No. 02 C 5403, 2003 WL 22595263 (D.C.N.D. Ill. Nov. 7, 2003), Bus. Franchise Guide (CCH) ¶ 12,699 (payments to third parties for construction improvements were ordinary business expenses). Note, however, that a fee paid by the franchisee “for the account of the franchisor” can be considered a required payment. See “When Does an Agreement Constitute a ‘Franchise?’” Release 3-F from the California Commissioner of Corporations, reprinted at Bus. Franchise Guide (CCH) ¶ 5050.45 (June 22, 1996). For example, “payments required in the franchise agreement to be made by the franchisee for advertising and promotion to enhance the goodwill of the franchisor’s business, even though the advertising and promotion also benefit the franchisee’s business, may be deemed made for the account of the franchisor, especially where the agreement gives the franchisor discretion to determine the manner and content of the publicity.” *Id.*

⁵² The Amended FTC Rule, 16 C.F.R. § 436.8(a)(1) (2007).

⁵³ 16 C.F.R. § 436.8(a)(1) (2007); see also FTC Informal Staff Advisory Opinion 98-5.

⁵⁴ Cal. Code Regs. Tit. 10, § 310.011 (2005); N.Y. Gen. Bus. Law § 681.7(e) (1996).

⁵⁵ See *To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc.*, Bus. Franchise Guide (CCH) ¶ 11,456 (7th Cir. 1998), affirming 953 F. Supp. 1987 (N.D. Ill. 1997) (holding that the required purchase of parts and service manuals with a value of \$1,600, over a period of eight years, was sufficient to satisfy the “fee” element of the franchise definition for purposes of Illinois law).

minimum payment exemptions provide ways for companies and practitioners to structure relationships so that they fall outside of the franchise disclosure and registration obligations, but they are not universally available.

Second, all jurisdictions (both state and federal) exclude from the fee element payments for inventory that do not exceed the bona fide wholesale price of inventory. The FTC expressly stated in its Statement of Basis and Purpose that this exemption extends to encompass both start-up inventory purchased at the franchisee's option and inventory purchased as a matter of contractual or practical necessity.⁵⁶ Although, some states have limited this bona fide wholesale exemption to a reasonable quantity of merchandise for which there is an actual market.⁵⁷

4. Exemptions, Exclusions and Jurisdictional Issues

A company wishing to franchise its concept, but also wishing to avoid the franchise disclosure and relationship statutes, must structure its system in such a way that it avoids one or more elements of the applicable franchise definitions. Doing so is not an easy task. As discussed above, the different franchise definition elements are often broadly interpreted making them hard to avoid. In addition, the same elements differ slightly between jurisdictions and, the same element may be interpreted differently in different jurisdictions. As a result, a work-around that is available in one jurisdiction may still fall squarely within the franchise definition of another jurisdiction.

For those intent on avoiding the applicability of federal and state franchise laws, exemptions and exclusions available under the franchise laws may also provide an out. The examination of all available exemptions is a topic in and of itself,⁵⁸ and this paper is only intended to provide a high level overview of available exemptions.

The federal and state law exemptions are created to carve out certain franchise relationships from the applicability of franchise laws because something in the exempt relationship reduces the risk that the franchisee will be taken advantage of by the franchisor and therefore doesn't require the same degree of government oversight as other franchise relationships are perceived to require. Unfortunately, what specific relationships lawmakers and regulators have deemed low-risk, and therefore exemption-worthy, vary tremendously between different jurisdictions. It would be an unusual feat to establish a functional, uniform franchise system that would be exempt in all U.S. jurisdictions. This does not mean exemptions are useless. Exemptions may not be the complete answer for the system that is planning to have nation-wide presence, but may still be helpful to the system that only intends to franchise in a few states or for the franchise system that has chosen to register only in a small number of

⁵⁶ The Statement of Basis and Purpose for the Amended FTC Rule, 72 Fed. Reg. 61, 15464-15465 (March 30, 2007), Bus. Franchise Guide (CCH) ¶ 6050.

⁵⁷ See, e.g., Cal. Comm. Op. Nos. 73/1F and 73/10F (advising that the bona fide wholesale price exception applies only if no obligation is imposed upon the purchaser to purchase or pay for a quantity of such goods in excess of that which a reasonable business person would normally purchase by way of a starting inventory or supply, or to maintain a going inventory or supply.); see also *Flynn Beverage Inc. v. Joseph E. Seagram & Sons, Inc.*, 815 F. Supp. 1174, Bus. Franchise Guide (CCH) ¶ 10,237 (C.D. Ill. 1993) (franchisee found when distributor was required to buy \$500 of new brand products for which there was no market).

⁵⁸ See Karen B. Satterlee and Leslie D. Curran, *Exemption-Based Franchising: Are You Playing in a Minefield?* Franchise Law Journal Vol. 28, No. 4, Spring 2009; as well as Jan S. Gilbert, Robin Day Glenn, Joan M. Painter and Karen B. Satterlee, *Managing a Franchise Registration and Exemption Practice*, American Bar Association 29th Annual Forum on Franchising, for excellent overviews of current state and federal exemptions.

states and is interested in completing a single transaction in a state where the franchise is not registered.

a. Specific exemptions

i. Federal

When the Amended FTC Rule came into force in 2007, it not only added new exemptions, but it also partially changed the scope of federal franchise regulation, and clarified that scope. The Amended FTC Rule also does not regulate the offer and sale of franchises to be located outside of the U.S. It does not matter if the prospective franchisee is a U.S. person or a foreigner.⁵⁹ Since there is no registration requirement under the Amended FTC Rule, if a sale is exempt under the Amended FTC Rule, the franchisor does not have to provide the franchisee with a franchise disclosure document at all, though state law may still impose such a requirement.

There are several different exemptions available under the Amended FTC Rule:

1. Minimum Payment Exemption,⁶⁰
2. Fractional Franchise Exemption,⁶¹
3. Leased Department Exemption,⁶²
4. Relationships covered by the Petroleum Marketing Practices Act, 15 U.S.C. 2801,⁶³
5. Sophisticated Investor Exemptions (Large Investment, Large Franchisee, Insider),⁶⁴ and
6. Oral Agreement Exemption.⁶⁵

Minimum Payment Exemption

The Minimum Payment Exemption is fairly self-explanatory: If before or during the first six months after beginning operations the franchisee is required to pay to the franchisor or its affiliates less than \$500 in total or commits to make such a payment during that time period, the Amended FTC Rule does not apply to the relationship. However, as discussed above, the franchise fee element of the franchise definition has been broadly interpreted, and many types of fees, including different “hidden” fees, can count towards the \$500 threshold. It is noteworthy that if during the time period the franchisee commits to pay money to the franchisor after the expiration of the time period those amounts do not count towards the \$500 threshold.⁶⁶ The

⁵⁹ As will be discussed below, while the Amended FTC Rule may not reach outside of the U.S. borders, some state laws may claim to extend their reach abroad.

⁶⁰ The Amended FTC Rule, 16 C.F.R. § 436.8(a)(1) (2007).

⁶¹ The Amended FTC Rule, 16 C.F.R. § 436.8(a)(2) (2007).

⁶² The Amended FTC Rule, 16 C.F.R. § 436.8(a)(3) (2007).

⁶³ The Amended FTC Rule, 16 C.F.R. § 436.8(a)(4) (2007).

⁶⁴ The Amended FTC Rule, 16 C.F.R. § 436.8(a)(5) and (6) (2007).

⁶⁵ The Amended FTC Rule, 16 C.F.R. § 436.8(a)(7) (2007).

⁶⁶ Federal Trade Commission, *Franchise Rule Compliance Guide*, at p. 7.

reasoning behind this exemption is that the minor financial investment made by the franchisee does not warrant the supervision of the FTC.⁶⁷

Fractional Franchise Exemption

Fractional franchises are defined under the Amended FTC Rule as a franchise relationship where (i) the franchisee or its directors or officers (or directors or officers of a parent or affiliate) have at least two years of experience in the same type of business as that of the franchise system, and (ii) the sales arising from the relationship are not expected to exceed 20% of the franchisee's total volume of sales during the first year of operations.⁶⁸ Experience in "the same type of business" is interpreted narrowly. The focus is on whether the prospective franchisee is already familiar with the goods or services to be offered under the new franchise system, and therefore is able to assess the financial risks involved in the venture.⁶⁹ Thus, experience in the same industry may not be sufficient to qualify a prospective franchisee for this exemption.

Leased Department Exemption

The leased department exemption applies where a retailer licenses a business to operate out of the retailer's location. The franchisee does not purchase any goods or services from the retailer. Examples of a leased department franchise are make-up or jewelry counters in department stores.⁷⁰

Sophisticated Investor Exemptions

Large Investment Exemption

If a franchisee's initial investment is \$1,000,000 or more, exclusive of funds from the franchisor and the cost of unimproved land, the franchise sale may qualify for the large investment exemption under Section 436.8(a)(5)(i) of the Amended FTC Rule, if none of the restrictions (outlined below) on this exemption apply.

In order to qualify for the exemption, the franchisee must sign an acknowledgement that the exemption applies and the transaction is excluded from the applicability of the Amended FTC Rule.⁷¹

If there is more than one investor acquiring the franchise, at least one investor must invest \$1,000,000 or more. It is not enough that multiple investors collectively invest \$1,000,000, if none of them invests above the threshold amount.⁷² The costs and expenses counted towards the "initial investment" means those costs and expenses disclosed in Item 7 of the franchise disclosure document. Investments made over the life of the franchise agreement, apart from those listed in Item 7, do not count towards the threshold amount.⁷³

In some respects, the large investment exemption is more permissive than may be apparent at first glance. For example, the \$1,000,000 threshold applies not only to single-unit

⁶⁷ *Supra*, note 56, at 15520.

⁶⁸ The Amended FTC Rule, 16 C.F.R. § 436.1(g) (2007).

⁶⁹ *Supra*, note 56, at 15459.

⁷⁰ The Amended FTC Rule, 16 C.F.R. § 436.1(l) (2007).

⁷¹ The Amended FTC Rule, 16 C.F.R. § 436.8(a)(5)(i)(2007).

⁷² *Supra*, note 56, at 15526.

⁷³ *Id.*

franchises, but is also applicable where a franchisee acquires rights to develop multiple units, and the total initial investment for those units exceeds the threshold amount.⁷⁴ A conversion franchisee can count all of its prior investments in the existing unit for purposes of meeting the threshold amount.⁷⁵

Large Franchisee Exemption

If the prospective franchisee has been in business for at least five years and has a net worth of \$5,000,000 or more, the transaction is also exempt from application of the Amended FTC Rule. In contrast to the fractional franchise exemption, this exemption does not require the prior experience to be the same kind of business as the franchised business.⁷⁶ The franchisee's business experience does not even have to be in the same industry as the franchised business. It is not necessary that the franchisee entity itself has the required business experience and net worth: the exemption also applies where it is the franchisee's parent or affiliate that has the required business experience or net worth.⁷⁷ The reasoning behind exempting sales to "large franchisees" from the protection of the Amended FTC Rule is that an entity that has operated for at least five years and has at least a \$5,000,000 net worth is likely to be sophisticated enough to negotiate the franchise agreement so as to protect its interests.⁷⁸

Insider Exemption

Where a majority ownership interest in the franchisee is held by one or more persons who are, or within 60 days prior to the acquisition have been, officers, owners, or managers of the franchisor with responsibility for the offer and sale of franchises, and that person or persons have held such positions for at least two years, the transaction is exempt from the Amended FTC Rule. Since the management responsibility of the franchisee has to be with respect to the offer and sale of franchises, the exemption does not apply to a franchisor who has not yet started to offer franchises to the public, but wants to offer units to insiders: the insider's prior management responsibility couldn't relate to offers and sales of franchises as the exemption requires.⁷⁹

Oral Agreement Exemption

A relationship that is not evidenced by any writing falls outside of the Amended FTC Rule.⁸⁰ This exemption likely will only apply in very limited circumstances since any writing, whether signed or not, brings the relationship back within the purview of the Amended FTC Rule. For example, it is enough to have a purchase invoice issued for goods or equipment for the Amended FTC Rule to apply.⁸¹

⁷⁴ *Supra*, note 56, at 15526.

⁷⁵ The Statement of Basis and Purpose for the Amended FTC Rule, 72 Fed. Reg. 61, 15526 (March 30, 2007), Bus. Franchise Guide (CCH) ¶ 6050. See also FTC Franchise Rule Compliance Guide, at 11, which clarifies that it is the franchisee's investment into its existing unit that matters for purposes of calculating the investment, not the current value of the unit.

⁷⁶ Federal Trade Commission, *Franchise Rule Compliance Guide*, at 13.

⁷⁷ *Supra*, note 56, at 15528.

⁷⁸ *Supra*, note 56, at 15527.

⁷⁹ Federal Trade Commission, *Amended Franchise Rule FAQ's*, FAQ no. 26 (available at www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml).

⁸⁰ 16 C.F.R. §436.8(a)(7) (2007).

⁸¹ Federal Trade Commission, *FTC Franchise Rule Compliance Guide*, at 9.

Exclusions

In addition to the exemptions from the Amended FTC Rule, several types of relationships are discussed as falling outside of the Amended FTC Rule in the Statement of Basis and Purpose: employment relationships, general partnerships, cooperatives, certification and testing services, and single trademark licenses.⁸² The general partnership and single trademark license exclusions are further discussed below.

ii. State

Just because a distribution model fits a federal exemption or exclusion does not mean that the state franchise disclosure laws will contain similar exemptions or exclusions. Currently, there is little consistency between the exemptions permitted by different state laws, and even exemptions that are similar by name may be different in fact. For example, minimum payment exemptions exist in many states,⁸³ but the minimum payment threshold differs from state to state and the period over which such payments must be made also varies between states.⁸⁴ Likewise, the large franchisor exemption exists in several states,⁸⁵ but, the franchisor's net worth and guaranty requirements vary if a parent or affiliate net worth is relied upon. Also, while a federal exemption eliminates a franchisor disclosure duty, state exemptions usually only exempt franchisors from state registration of their franchise disclosure document, but still require disclosure.

In recent years, several states have revised their franchise law exemptions. Rhode Island has added an insider exemption for sales to officers and directors of the franchisor,⁸⁶ and South Dakota eliminated its large franchisor exemption. Virginia added several new exemptions: a large franchisor exemption, sale of additional franchises to existing franchisees, sale by franchisees of their units, and sales to banks and other financial institutions.⁸⁷ At the time of writing, in Illinois, amendment to the Illinois Franchise Disclosure Act is pending the governor's signature. If signed into law, the amendment will add several new exemptions, including a large franchisee exemption and an insider exemption to the statute. A chart of federal and state law exemptions is attached at the end of this paper.

NASAA, the North American Security Administrators' Association, has a project under way to create more consistency amongst state and federal exemptions. A formal proposal from the NASAA project group may be presented for public comment as early as this fall. The exemptions to be proposed will likely include a fractional franchise exemption, a seasoned franchisor exemption,⁸⁸ sophisticated franchisee exemption, as well as a discretionary

⁸² *Supra*, note 56, at 15520.

⁸³ Cal. Code Regs. Tit. 10, §310.011 (1996); 815 Ill. Comp. Stat 705/3 (c)(2008); Md. Code Regs. 02.02.08.10 C (2009); Mich. Comp. Laws §445.1506(1)(c) (2002); Minn. Stat. §80C.01(c) (2009); Wash. Rev. Code § 19.100.030 (4) (1999); and Wis. Admin. Code §32.05(1)(b) (2009).

⁸⁴ See *To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift Am., Inc.*, Bus. Franchise Guide (CCH) ¶ 11,456 (7th Cir. 1998), affirming 953 F. Supp. 1987 (N.D. Ill. 1997) (which considered payments made over several years in determining if there was a franchise fee).

⁸⁵ Cal. Corp. Code §31101 (2006); Ill. Admin. Code tit. 14 § 200.202 (e) (2008); Ind. Code § 23-2-2.5-3 (2005); Md. Code Regs. 02.02.08.10 E (2009); N.Y. Gen. Bus. §684 (2)(a) (1996); N.D. Cent. Code § 51-19-04 (2008); R.I. Gen. Laws §19-28.1-6; 21 (2006); Va. Admin. Code § 5-110-75 (2006); and Wash. Rev. Code §19.100.030(4) (1999).

⁸⁶ R.I. Gen. Laws § 19-28.1-6(c) (2006).

⁸⁷ Va. Code Ann. § 5-110-75 (2006).

⁸⁸ This exemption would, like the FTC seasoned franchisor exemption, require a certain operating history and net worth. Given the current economic climate and the volatility of many venerable companies, this exemption may not be included in the final proposal.

exemption. Except for the fractional franchise exemption, the proposed exemptions would only exempt franchisors from registration, but not from disclosure.

b. Jurisdictional issues: scope of franchise laws

An additional difficulty in determining applicability of franchise laws is the jurisdictional scope of franchise disclosure laws. The Amended FTC Rule settled once and for all that the scope of federal franchise regulation is limited to franchised businesses that will be located in the U.S. and its territories.⁸⁹ State laws are not, however, always limited to transactions occurring within the borders of the state; sometimes state laws reach any franchise transactions involving citizens of the state, no matter where the franchised unit is to be located or, conversely, apply to transactions involving a business which will be operated in the state even if neither party is a resident and no pre-sale communications take place in the state.⁹⁰

Most statutes specifically exclude “out of state sales” from their scope, but define out of state sales only as sales to a citizen of another state of a franchise to be located and operated completely outside of the state.⁹¹ By negative inference, it would follow then that a sale to a person domiciled in a state who wants to buy a franchise to be located and operated outside of that state is still covered by the state statute. In addition, under some statutes, other factors, such as where a franchise agreement was negotiated and signed, will affect its applicability.⁹²

Another aspect of the scope of the out-of-state exemptions may also make the exemption narrower than franchisors may expect. For example, the California out-of-state exemption has been interpreted to only apply to registration and disclosure obligations, but not to other sections of the California franchise statute, such as anti-fraud provisions in the statute.⁹³

The complexity of determining what state law applies to a relationship is highlighted in *Goldwell of New Jersey, Inc. v. KPSS, Inc.*⁹⁴ in which, on summary judgment motions, the U.S. District Court for the District of New Jersey analyzed an alleged franchise relationship between a manufacturer of hair care products and one of its distributors, and whether the manufacturer had violated the New Jersey Franchise Practices Act (“NJFPA”) by failing to renew the parties’ agreements. The parties had entered into three separate distribution agreements, only one of which covered New Jersey. The court held that while a franchise agreement covering multiple states, including New Jersey, could be subject to the NJFPA in its entirety, it was not the case where the parties had entered with separate agreements for different states.⁹⁵ However, the court’s analysis went beyond the letter of the agreements in determining NJFPA applicability. It also looked to the actual conduct of the parties taking into account that the distributor would place aggregated, cross-territorial orders for products; that the manufacturer shipped orders to the distributor’s New Jersey location; and that the sales reports of the distributor aggregated

⁸⁹ 16 C.F.R. § 436.2 (2007).

⁹⁰ See, e.g., Va. Code Ann. § 13.1-559.B (2007, pocket part 2009).

⁹¹ See e.g., Cal. Corp. Code § 31105 (2006), Bus. Franchise Guide (CCH) ¶ 3050.28; Haw. Rev. Stat. § 482E-4 (2008), Bus. Franchise Guide (CCH) ¶ 3110.04.

⁹² See, e.g., Cal. Corp. Code § 31013 (2006), Bus. Franchise Guide (CCH) ¶ 3050.15 (the California statute applies where the offer was made in the state, accepted in the state, and where the offer was received in the state); 815 Ill. Comp. Stat. 705/3(20) (2008), Bus. Franchise Guide (CCH) ¶ 3130.03 (the Illinois statute applies where the offer originates from the state, is directed to the state, and where acceptance is communicated to or from the state).

⁹³ *It’s Just Lunch Int’l LLC v. Island Park Enter. Group, Inc.*, No. EDCV 08-367-VAP (JCRx), 2008 WL 4683637 at 4 (C.D. Cal. Oct. 21, 2008).

⁹⁴ *Goldwell of New Jersey, Inc. v. KPSS, Inc.*, ---F.Supp.2d ---, 2009 WL901158, Bus. Franchise Guide (CCH) ¶ 14,111 (D. N.J.)

⁹⁵ *Goldwell of New Jersey, Inc.* at 16.

sales numbers for the territories under all of its distribution agreements.⁹⁶ Based on the parties' conduct, the court refused to rule that, as a matter of law, the NJFPA would not apply to the agreements for other states.

A discussion of scope of franchise law would be incomplete without mentioning that the State of New York takes an unusually broad approach to its regulatory powers. There are two peculiar aspects to the New York statute. First, the definition of a franchise is very broad.⁹⁷ Second, the statute lacks the type of out-of-state sales exemption that state franchise laws usually have. Under the New York Franchise Act, an offer or sale is considered made in the state, when the actual offer is made in the state, the offer is accepted in the state, the franchisee is domiciled in the state, or the franchised business will be operated in the state. It is also made in the state when the offer originated from the state or is directed to the state.⁹⁸ While this type of provision is not unusual, without an exemption of sales where neither the franchisee is domiciled in the state nor the franchise will be operated in the state, any negotiations in New York of an agreement otherwise unrelated to the state, will be subject to its franchise law.⁹⁹ Also, a franchisor who is located in New York, but does not sell franchises in the state, would still be required to register in the state before being able to sell any franchises.

5. Differences Between the Scope of State Disclosure Laws and Relationship Laws

The franchisor or distributor who is able to avoid registration of its franchise disclosure document or disclosure altogether in the sale of system units cannot assume that it has made it out of the franchise regulatory maze. The regulation of franchises goes beyond just proper disclosure; in fact, much regulation awaits the course of the relationship. Those laws and regulations may be applicable to distribution systems that are not considered franchises under the state or federal disclosure laws, or that were subject to an exemption from registration or were exempt from disclosure altogether.

All of the states requiring registration or filing of the franchise disclosure document, except for New York and North Dakota, regulate the ensuing relationship between franchisors and franchisees. Most common are regulations of the franchisor's right to terminate the franchise agreement, and the franchisor's obligations to the franchisee upon renewal of the

⁹⁶ *Goldwell of New Jersey, Inc.* at 17.

⁹⁷ The New York statute contains two parallel franchise definitions. The first one defines a "franchise" as an agreement by which a franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor, and the franchisee is required to pay a franchise fee. The second defines a "franchise as an agreement by which a franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate, and the franchisee is required to pay, directly or indirectly, a franchisee fee. See N.Y. Bus. Corp. Law § 681 (1996). Thus, instead of defining a franchise by three elements, in New York, an agreement is a franchise if there is either a marketing plan or trademark association (in each case coupled with the payment of a franchise fee). The exceptionally broad definition was motivated by a desire to stem corruption in the state and ensure the public that New York was a good place to do business. However, it has also been argued that the broad definition unintentionally sweeps agreements such as trademark license agreements within its scope and as such dissuades franchisors from setting up business in New York. Thomas M. Pitegoff, *Franchising in New York After the Revised FTC Rule*, NY Business Law Journal, Fall 2007, Vol. 11, No. 2 at 17.

⁹⁸ See N.Y. Bus. Corp. Law § 681 (1996).

⁹⁹ See *Mon-Shore Management, Inc. v. Family Media, Inc.*, 584 F. Supp 186 (S.D.N.Y. 1984). Even a franchise intended to be located abroad would fall within the scope of the statute if, for example, the parties negotiate the franchise agreement in New York.

agreement.¹⁰⁰ However, some statutes go further, regulating discrimination between franchisees, the franchisor's right to collect rebates from suppliers to the franchisees (Indiana¹⁰¹), and even the minimum length of the term of the agreement (Connecticut¹⁰²).

For states regulating disclosure, the discrepancy between disclosure laws and relationship laws should not be overstated. A distribution system that does not fall within the definition of a franchise for purposes of registration will, in most states, also be able to avoid applicability of the relationship statutes. However, several of the registration states—Maryland, Rhode Island and Wisconsin—do not have relationship provisions in their franchise laws, but instead regulate a broader scope of distribution arrangements through their fair distributorship statutes. For example, the Wisconsin Fair Dealership Law defines a “dealership” as:

[a] contract ... by which a person is granted the right to sell or distribute goods or services, or use a trade name, trademark, service mark, logotype, advertising or other commercial symbol, in which there is a community of interest in the business of offering, selling or distributing goods or services at wholesale, retail, by lease, agreement, or otherwise.¹⁰³

“Community of interest” is defined as “a continuing financial interest between the grantor and grantee in either the operation of the dealership business or the marketing of such goods or services.”¹⁰⁴ Thus, distribution systems that do not fall under the disclosure statutes in Maryland, Rhode Island and Wisconsin may be within the scope of the post-sale statutes in those states.

Many states that do not regulate franchise disclosure, where franchise disclosure is therefore only regulated by the Amended FTC Rule, regulate the ensuing franchise relationship. There is a plethora of relationship statutes in non-registration states. Some regulate franchising in general, while other statutes regulate franchising in certain industries only, such as motor vehicle dealerships, farm and industrial equipment distributorships, and liquor distributorships. Of the states that regulate franchising in general, some statutes cover only franchise relationship,¹⁰⁵ with definitions of a franchise similar to those found in state registration statutes, but other statutes use definitions that are broader.¹⁰⁶ Of the states with broad definitions, many incorporate the “community of interest” element into their franchise definitions.¹⁰⁷ Also, in many states there are relationship statutes that apply not only to “franchises,” but to distributorships in general, just as the Maryland, Rhode Island and Wisconsin post-sale statutes. Finally, there are a few state statutes that may take even the seasoned franchisor, used to state regulation, by surprise. For example, Louisiana has a statute that specifically regulates non-competition

¹⁰⁰ See Cal. Bus. & Prof. Code § 8-5.5-20020 (2006) (termination) and Cal. Bus. & Prof. Code §8-5.5-20025 (2006) (renewals); 815 Ill. Comp. Stat. Ann. 705/19-20 (West 2008); Ind. Code Ann. § 23-2-2.7-3 (West 2005); Md. Code Ann. Com. Law §§ 11-1302.1 and 11-1302.2 (2002); Minn. Stat. § 80C.14 (2009); R.I. Gen. Laws § 6-50-4 (2006, 2009 pocket part), Wash. Rev. Code Ann. § 19.100.180(j) (West 1999); and Wis. Stat § 135.04 (2009).

¹⁰¹ Ind. Code § 23-2-2.7-1(3) (2005).

¹⁰² Conn. Gen. Stat §42-133 f(d) (2007).

¹⁰³ Wis. Stat. § 135.02 (3)(a) (2009).

¹⁰⁴ Wis. Stat. § 135.02 (1) (2009).

¹⁰⁵ See, e.g., Idaho Code Ann. §29-110 (2006) and Iowa Code §523H.1 (2005) and §537A.10 (1997, 2009 pocket part).

¹⁰⁶ See, e.g., Ark. Code Ann. §4-72-202 (2004), Conn. Gen. Stat. § 42-133e (2007); and P.R. Laws Ann. Tit. 10 §278 (2004).

¹⁰⁷ See, e.g., Miss. Code Ann. §75-24-51 (6) (1999), Mo. Rev. Stat. § 407.400 (2001, 2009 pocket part), Neb. Rev. Stat. §87-402 (2007), and N.J. Stat. Ann §56:10-3(a) (2001).

restrictions with franchisees. Kansas recently enacted a statute that voids certain indemnification provisions and insurance requirements in franchise agreements, as well as forum selection clauses.¹⁰⁸

A case demonstrating a relationship not subject to disclosure laws that was nonetheless subject to the relevant relationship statute is *Fitzpatrick v. Teleflex, Inc.*¹⁰⁹ In this case, a manufacturer terminated the distributor of truck heat/cooling components when the manufacturer found an alternative national distributor for its products. The distributor sought the protection of the Maine Franchise Law for Power Equipment, Machinery and Appliances (“MFLPE”) against the termination without cause. Under MFLPE, a “franchise” is defined as “an oral or written arrangement ... pursuant to which a manufacturer grants to a dealer or distributor of goods a license to use a trade name, trademark ... and in which there is a community of interest in the marketing of goods and services ...”¹¹⁰ At the outset of the relationship, the dealer Fitzpatrick had received a letter saying he was part of the “Teleflex Family”, and that Teleflex would advertise Fitzpatrick as one of its exclusive distributors and expected Fitzpatrick to invest time and money to help develop the market for its products as well as the products themselves.¹¹¹ On those facts, the court found that the plaintiff had alleged sufficient facts to support plausible grounds to infer a “community of interest.”¹¹²

The regulatory landscape in this area continues to change. Over the last couple of years, there have been efforts made by state legislatures in several states to introduce new relationship statutes. For example, Arizona is considering the introduction of a statute that would require franchisors to renew agreements unless there has been a material breach of the franchise agreement.¹¹³ Likewise, Massachusetts has been contemplating a statute requiring good cause for terminations and renewals.¹¹⁴ For existing agreements with potential to fall within the scope of such new relationship laws, these prospective laws should not be of concern, since statutes usually are not retroactively applied. However, in recent years, some states have taken a creative approach to what constitutes retroactive application and, at least in cases where agreements have lacked explicit term provisions, interpreted such agreements as continuously renewing, thereby being able to apply to statutes enacted long after the agreements were entered into. This was the case in *John Deere Construction and Forestry Co. v. Reliable Tractor*.¹¹⁵ In 1984, Reliable entered into a dealer agreement with John Deere to operate as an authorized dealer. The agreement provided that John Deere could terminate without cause upon 120 days’ notice. In 2007, John Deere gave Reliable notice pursuant to the termination provision. The Maryland Court of Appeals was faced with the issue of whether the Maryland Equipment Dealer Contract Act, enacted in 1987, which requires good cause for termination, applied to the case before it. The court found that the statute applied reasoning that since the contract provided that it could be terminated upon 120 days’ notice, at no time could the parties expect that the agreement would last for more than 120 days from any given date.¹¹⁶ “By continuing to perform their obligations under the contracts without providing notice

¹⁰⁸ Kan. Stat. Ann. §16-121 (2007, 2008 pocket part).

¹⁰⁹ *Fitzpatrick v. Teleflex, Inc.*, No. CV-08-400-B-W, 2009 WL 393406 (D. Me. June 29, 2009).

¹¹⁰ Me. Rev. Stat. Ann. tit 10, §1361(3).

¹¹¹ *Fitzpatrick* at 2-3.

¹¹² *Fitzpatrick* at 7.

¹¹³ HB 2582.

¹¹⁴ SB 142, 2007 session.

¹¹⁵ *John Deere Const. & Forestry Co. v. Reliable Tractor*, 957 A.2d 595, 600 (Md. 2008).

¹¹⁶ *John Deere* at 600.

of termination, the parties effectively renewed their contracts consistent with the applicable law in effect at the time.”¹¹⁷

Another issue facing the franchisor who is trying to assess state franchise laws is that states will frequently consider franchise laws as involving state fundamental policies and may not enforce contractual choice-of-law provisions. In *New England Surfaces v. E.I. DuPont de Nemours and Company*,¹¹⁸ the First Circuit reviewed a franchise agreement between DuPont, based in Delaware, and New England Surfaces, based in Maine. The franchise agreement provided that it was to be governed by Delaware law. New England Surfaces operated in Maine, Rhode Island and Connecticut. Before the court was the issue of whether the Connecticut Franchise Act applied to the agreement. The statute, like many other franchise relationship statutes, applies exclusively to franchise agreements—“the performance of which contemplates or requires the franchisee to establish or maintain a place of business in [Connecticut].”¹¹⁹ The statute also voids any waiver of its applicability.¹²⁰ The court found that a choice-of-law clause can be abrogated in two situations: if there is a provision in the agreement between the parties that specifically does this, or if one state has a materially stronger interest in the agreement than the choice-of-law provision states.¹²¹ The court concluded that Connecticut had a fundamental policy against terminating Connecticut franchisees at will, and that it was not clear whether Delaware’s policy in this respect was materially greater and remanded the claim to the trial court.¹²² Other courts yet have held that out-of-state exemptions apply only to initial sales and not to renewals.¹²³

B. Business Opportunity Statutes - The Elements

1. Introduction

In addition to laws regulating franchises, 26 jurisdictions in the United States have adopted laws governing the sale of “business opportunities.”¹²⁴ The FTC Rule entitled “Disclosure Requirement and Prohibitions Concerning Business Opportunities” also requires disclosure in business opportunity offerings.¹²⁵ In their simplest form, business opportunities

¹¹⁷ *John Deere* at 600.

¹¹⁸ *New England Surfaces v. E.I. DuPont de Nemours and Co.*, 546 F.3d 1 (1st Cir. 2008), Bus. Franchise Guide (CCH) ¶ 13,989.

¹¹⁹ Conn. Gen. Stat. § 42-133h (2007).

¹²⁰ Conn. Gen. Stat. § 42-133f (2007).

¹²¹ *New England Surfaces* at 10.

¹²² *It's Just Lunch Int'l LLC v. Island Park Enter. Group, Inc.*, No. EDCV 08-367-VAP (JCRx), 2008 WL 4683637 at *4 (C.D. Cal. Oct. 21, 2008).

¹²³ *Mahroom v. Best Western Int'l, Inc.*, No. C 07-2351 JF (HRL), 2007 WL 2123565 at *5 (N.D. Cal. July 23, 2007).

¹²⁴ Alabama, 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 and Washington have adopted business opportunity laws. In addition, consumer protection laws of Tennessee and the District of Columbia expressly prohibit fraudulent practices or conduct in connection with the sale of business opportunities.

¹²⁵ Note that, prior to July 1, 2008, the Original FTC Rule was entitled “Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities” and covered both franchises and business opportunities under one part. The “new FTC Rule” (16 C.F.R § 436), which came into effect on July 1, 2008, no longer applies to business opportunities. Business opportunities are now addressed separately at 16 C.F.R § 437. The proposed new Business Opportunity Rule, which, as of June 1, 2009, was not finalized, includes a slightly different definition for business opportunities and has less stringent disclosure requirements. The current draft of the proposed rule requires pre-sale disclosures for business opportunities if the following elements are met:

might be described as packaged business investments that allow buyers to begin a business. However, unlike a franchisor, the business opportunity seller typically exercises little or no control over the buyer's business operations. Some common examples of business opportunities are vending machine routes and work-at-home businesses.

The business opportunity laws were originally designed to protect innocent investors when purchasing a business to sell goods or services at retail using racks or vending machines, or entering other questionable ventures. They have since been applied to numerous business ventures. While the specifics of the statutes vary, the state business opportunity laws usually cover a relationship where a "seller" provides or offers to provide or sell products, equipment, supplies, or services to enable a "purchaser" to start or, in some states, to operate a business. The laws generally make it unlawful to offer or sell business opportunities without appropriate presale disclosure and (where required) registration. Usually, sellers must also be able to substantiate any earnings claims they make to potential purchasers and some states impose burdensome bond requirements.

In some states, the business opportunity law is the state's only statute imposing registration or disclosure requirements on business opportunities, while, in others, the business opportunity laws coexist with franchise disclosure and registration laws.

2. The Elements

In general terms, a business opportunity is defined by the following four elements:

- 1) A seller directly or indirectly provides goods or services to the buyer.
- 2) The goods or services provided enable the buyer to start a business.
- 3) The seller makes one or more enumerated representations about the business to the buyer.
- 4) The buyer pays some sort of consideration in exchange for the goods or services.¹²⁶

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(a) The purchaser sells goods or services supplied by the seller or its affiliate, or by suppliers with which it is required by the seller to do business;

(b) The seller secures retail accounts for the goods or services, or secures locations for vending devices or racks, or provides the services for a person to do either; and

(c) The purchaser is required to pay the franchisor or its affiliates, within six months after commencing operation of the purchaser's business, \$500 or more in order to obtain or commence the business.

¹²⁶ The Illinois Business Opportunity Sales Law (Ill. Bus. Opp Sales Law of 1995, Bus. Franchise Guide (CCH) ¶ 3138) is a typical state business opportunity statute and defines a "business opportunity" as:

[A] contract or agreement, between a seller and purchaser, express or implied, orally or in writing, wherein it is agreed that the seller or a person recommended by the seller shall provide to the purchaser any product, equipment, supplies or services enabling the purchaser to start a business when the purchaser is required to make a payment to the seller or a person recommended by the seller and the seller represents directly or indirectly, orally or in writing, any of the following, that:

(1) The seller or a person recommended by the seller will provide or assist the purchaser in finding locations for the use or operation of vending machines, racks, display cases or other similar devices, on premises neither owned nor leased by the purchaser or seller;

a. Goods / Services

This first element is fairly straightforward and is satisfied in any arrangement whereby the seller provides goods or services of any kind to a buyer. The goods or services may be provided directly by the seller to the buyer or, in most cases, indirectly by the seller through one of its affiliates or a recommended third party. Also, this element is satisfied even if the goods or services are leased, rather than sold, to the buyer.

b. Starting a Business

The second element of a business opportunity is met if the goods or services provided enable the buyer to start a business. This element creates a distinction between “business opportunities” and arrangements where a seller is simply selling goods or services to an end user or to an existing business operator. This distinction is in line with the general purpose behind the disclosure requirements of the business opportunity laws to assist a prospective buyer that is considering starting a risky business venture. However, in a few states, this element is satisfied if the goods or services are used either to start a business or to *continue* the operation of an existing business.¹²⁷

c. Fee / Payment of Consideration

Like the franchise statutes, the state business opportunity laws are typically triggered only if the buyer is required to pay some sort of consideration in exchange for the business opportunity. However, the “fee” element of the business opportunity statutes is considerably less uniform among the states than in the case of the franchise statutes.

The majority of the statutes have a minimum dollar amount threshold that must be met before the statute will apply.¹²⁸ In California and Illinois (as well as other states), for instance, the business opportunity statute is only triggered if the buyer makes an initial payment of more than \$500. While in other states, the initial expenditure/investment threshold is even lower (e.g.,

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(2) The seller or a person recommended by the seller will provide or assist the purchaser in finding outlets or accounts for the purchaser's products or services;

(3) The seller or a person specified by the seller will purchase any or all products made, produced, fabricated, grown, bred or modified by the purchaser;

(4) The seller guarantees that the purchaser will derive income from the business which exceeds the price paid to the seller;

(5) The seller will refund all or part of the price paid to the seller, or repurchase any of the products, equipment or supplies provided by the seller or a person recommended by the seller, if the purchaser is dissatisfied with the business; or

(6) The seller will provide a marketing plan, provided that this Law shall not apply to the sale of a marketing plan made in conjunction with the licensing of a federally registered trademark or federally registered service mark.

¹²⁷ California Civil Code Section 1812.201(a) (2009); Indiana Code 24-5-8-1 (2006); Nebraska Rev. Stats. 1943, Chapter 59, Article 17, Section 59-1703 (2006).

¹²⁸ Three of the state statutes, California, Indiana and Ohio, also have a maximum payment threshold of \$50,000. Thus, if the consideration paid by the buyer to the seller is greater than \$50,000 the arrangements would not be subject to these states' business opportunity statutes.

\$100 in Minnesota and \$300 in Louisiana). Some state statutes, in fact, have no minimum expenditure requirement at all.¹²⁹

In addition to providing differing minimum dollar thresholds, the specific statutory language regarding the buyer's minimum expenditure varies greatly from state to state. For example, the California Seller Assisted Marketing Plan Act requires "an initial required payment over \$500"; the Oklahoma Business Opportunity Sales Act requires a payment "of over \$500 *within the first year*"; and the South Dakota business opportunity statute requires an "initial payment of \$250 or more *during the first six months*."¹³⁰ Further, the fee element of some of the statutes only comes into play if the fee is paid in consideration for a marketing program.¹³¹

Finally, the vast majority of the statutes specifically provide that they do not apply to not-for-profit sales of demonstration equipment, materials or samples when the total costs for such equipment and materials does not exceed a certain dollar amount—typically \$500.¹³²

As a result of the numerous differences between the state statutes with respect to the minimum initial investment or expenditure requirement, sellers must pay close attention to the specific language of any potentially applicable business opportunity statute to determine whether the consideration they receive may subject them to the statutory disclosure and registration requirements.

Assuming the other three definitional elements are present, the state business opportunity statutes will likely be triggered if, in connection with offering the business venture, the seller makes any one of several stated representations to a prospective buyer. Sellers should bear in mind that this element is satisfied by both written and oral representations, and even express written disclaimers of representations do not relieve a seller from complying with a business opportunity statute.¹³³ Also, the specific triggering representations vary from statute to statute, and sellers wishing to avoid the application of business opportunity laws must analyze each potentially applicable statute independently.

d. Representations

The most challenging element to assess in determining whether a business is a "business opportunity" is whether the seller makes certain triggering representations to the buyer. The most often listed representations include:

- 1) The business opportunity buyer will earn more money than he pays for acquiring the goods or services.
- 2) The seller will provide the buyer with a marketing plan.

¹²⁹ See, e.g., Code of Alabama 1975, Title 8, Chapter 19, Sections 8-19-1 through 8-19-15 (2002); Nebraska Rev. Stats. 1943, Chapter 59, Article 17, Sections 59-1703 to 59-1714.01 (2006); New Hampshire Rev. Stats Annotated, 1977 Supplement, Title XXXI, Section 358-E:1 (2009).

¹³⁰ California Civil Code Section 1812.201(a) (2009); Okla. Stat. tit. 71, §803 (2009); South Dakota Codified Laws and 1989 Pocket Supplement, Title 37, Section 37-25A-3(2) (2004, pocket part 2009).

¹³¹ See e.g., Ga. Code Ann. § 10-1-410 (2003) (including as one of the enumerated "triggering representations" that "the company, in conjunction with any agreement which requires a total initial payment of an amount exceeding \$500.00, will provide a sales program or marketing program...").

¹³² See e.g., Conn. Gen. Stat. §36b-60 (2004).

¹³³ See e.g., *Martin v. Pilot Indus.*, 632 F.2d 271 (4th Cir. 1980).

- 3) The seller will provide locations or location assistance for vending machines or racks to be serviced by the buyer.
- 4) The seller will provide the buyer with leads or will itself purchase the goods or service to be offered by the buyer.
- 5) The investment is free of risk.
- 6) The seller will buy back some or all of the goods sold to the investor.

C. Industry Specific Statutes

In addition to state laws governing the franchisee/franchisor relationship and business opportunity laws, a number of states have enacted industry-specific laws, such as those regulating motor vehicle dealers, beer and wine distributors, and farm and other heavy equipment dealers. The federal government has also enacted statutes protecting automobile dealers and petroleum franchisees.

1. Automobile Dealers' Day in Court Act¹³⁴

Congress enacted the Automobile Dealers' Day in Court Act ("ADDCA") in 1956 in order to provide automobile dealers with basic protections and a federal forum to hear their grievances. The ADDCA provides remedies for dealers who have been injured as a result of a manufacturer's unlawful conduct.

To assert a claim under the ADDCA, a dealer must establish five elements. First, the party must show that it meets the ADDCA's definition of "dealer," which is defined as any entity "operating under the terms of a franchise and engaged in the sale or distribution of passenger cars, trucks or station wagons."¹³⁵ Second, the defendant must be a "manufacturer"—that is, an entity "engaged in the manufacturing or assembly of passenger cars, trucks or station wagons."¹³⁶

Third, the dealer must show that the manufacturer failed to comply with the written franchise agreement or wrongfully terminated the franchise.¹³⁷ Then, the dealer must establish that the manufacturer's actions were not in good faith.¹³⁸ The majority of litigation revolves around this fourth factor. Courts generally define "good faith" narrowly, holding for example that general "unfairness" is insufficient to satisfy the ADDCA's requirement that a manufacturer act

¹³⁴ 15 U.S.C. §§ 1221-1225.

¹³⁵ *Id.* at § 1221(c). It is the entity itself – and not the shareholders or officers – that is the "dealer" under the statute's definition. See *Pearson v. Ford Motor Co.*, 68 F.2d 1301, 1303 (11th Cir. 1995).

¹³⁶ *Id.* at § 1221(a). Notably, manufacturers of buses, tractors, motorcycles and other motor vehicles do not fall under the ADDCA's definition of "manufacturer." See *River Oaks Motor Homes, Inc. v. Winnebago Indus., Inc.*, 371 F. Supp. 137, 140 (S.D. Tex. 1974).

¹³⁷ *Id.* at § 1222.

¹³⁸ *Id.* The ADDCA defines "good faith" as the duty of parties to a franchise agreement "to act in a fair and equitable manner toward each other so as to guaranty the one party freedom from coercion, intimidation, or threats of coercion or intimidation from the other party." *Id.* at § 1221(e).

without good faith.¹³⁹ Rather, to establish “good faith,” the dealer must show “actual or threatened coercion or intimidation.”¹⁴⁰

Despite this high standard for establishing a lack of good faith, it is not impossible for an automobile dealer to make such a showing. In *North Broadway Motors v. Fiat Motors*, the court held that the dealer alleged a valid claim under the ADDCA when the automobile manufacturer insisted that the dealer accept certain cars and parts that the dealer did not want or risk being in violation of an “adequate stock” requirement in the franchise agreement.¹⁴¹ However, a dealer’s simple assertion that a manufacturer unreasonably delayed in issuing credits or paying money due to the dealer was insufficient evidence of bad faith when the dealer did not present any evidence that the manufacturer used the conduct to coerce the dealer against its will.¹⁴²

The final requirement for establishing a claim under the ADDCA is to show that the manufacturer’s conduct actually caused the dealer’s injury.¹⁴³ A wronged dealer can recover those damages sustained as a result of the manufacturer’s conduct, which can be measured in terms of both future and present lost profits. Further, the dealer can recover his costs in bringing the action (although not attorneys’ fees).¹⁴⁴

2. State Motor Vehicle Dealer Acts

In addition to the ADDCA, all states have enacted a version of the federal act, and the state legislation is generally more detailed than the federal legislation.

Specifically, state statutes often contain extensive lists of conduct constituting “unlawful practices.” For example, state motor vehicle statutes often contain provisions similar to state franchise acts, governing the manner and terms of termination, cancellation or nonrenewal of the parties’ relationship.¹⁴⁵ Additionally, state motor vehicle statutes often contain provisions regulating transfer of the dealership and the manufacturer’s power to restrict the dealer’s transfer.¹⁴⁶

Many state automobile laws require that manufacturers provide dealers with some sort of compensation upon termination.¹⁴⁷ Further, dealers that are damaged by a manufacturer’s violation of state motor vehicle law may have the right to injunctive relief and/or damages.¹⁴⁸

3. Petroleum Marketing Practices Act¹⁴⁹

The Petroleum Marketing Practices Act (“PMPA”) was adopted in 1978 and focuses mainly on termination and non-renewal issues. The PMPA gives franchisees a federal cause of action, including the ability to obtain injunctions.¹⁵⁰

¹³⁹ See *Autohaus Brugger, Inc. v. South Motor, Inc.*, 567 F.2d 901, 911 (9th Cir. 1978) (defining “good faith” under the ADDCA as actions that are “unfair and inequitable in addition to being for the purpose of coercion and intimidation”).

¹⁴⁰ *Wagner and Wagner Auto Sales, Inc. v. Land Rover North Am., Inc.*, 539 F. Supp. 2d 461, 473 (D. Mass. 2008).

¹⁴¹ 622 F. Supp. 466, 472-473 (D.C. Ill. 1984).

¹⁴² *Cycil Corley Motor Co. v. Gen. Motors Corp.*, 380 F. Supp. 819, 841-848 (M.D. Tenn. 1974).

¹⁴³ 15 U.S.C. § 1222.

¹⁴⁴ *Id.*

¹⁴⁵ See, e.g., Cal. Vehicle Code § 3060 (2000); Fla. Stat. Ann. § 320.641 (2005, pocket part 2009).

¹⁴⁶ See, e.g., Conn. Gen. Stat. § 42-1330Y (2007).

¹⁴⁷ See, e.g., Ala. Code § 20-5(f) (2009); Mass. Gen. L. ch. 93B, § 9 (2006).

¹⁴⁸ See, e.g., N.Y. Veh. & Traf. L. § 469 (1996 pocket part 2009).

¹⁴⁹ 15 U.S.C. § 2801 *et seq.*

The PMPA applies to “franchises,” defined as any contract between a refiner and a distributor, a refiner and a retailer, a distributor and another distributor, or a distributor and a retailer, whereby the refiner or the distributor occupies leased marketing premises that are “employed in connection with the sale, consignment, or distribution of motor fuel under a trademark which is owned or controlled by such refiner or by a refiner that supplies motor fuel to the distributor.”¹⁵¹ More simply put, a PMPA franchise is generally any arrangement to sell or distribute motor fuel under a refiner’s trademark.

The PMPA lays out 12 events that constitute permissible grounds for terminating or failing to renew the franchise relationship.¹⁵² All other terminations or non-renewals are prohibited by the PMPA.

Under the PMPA, courts are empowered to grant equitable relief in order to remedy a franchisor’s failure to comply with the statute.¹⁵³ Further, a wronged franchisee may recover its actual damages suffered as a result of wrongful termination, and a court may award exemplary damages if it finds that a franchisor willfully disregarded the requirements of the PMPA.¹⁵⁴

4. Beer & Wine Distributors

Most states provide some protection for beer and wine distributors through industry-specific regulations. Some states require that the parties have a written franchise agreement for the statute to apply; others do not require a written agreement, but may imply a franchise agreement once the parties have worked together for a stated amount of time.¹⁵⁵

State beer and wine laws generally make it unlawful for a brewer to attempt to induce or coerce any wholesaler to accept deliveries of alcoholic beverages that the wholesaler did not order.¹⁵⁶ The state laws also usually prohibit a brewer from inducing or coercing the wholesalers to perform illegal acts by threatening to terminate, fail to renew, or otherwise change the parties’ agreement.¹⁵⁷

Like other industry-specific statutes, beer and wine wholesaler laws typically contain provisions governing termination, which commonly require good cause to terminate and notice of intent to terminate. Remedies under these statutes generally include actual damages suffered as consequence of the brewer’s violation, with the measure of damages defined as the lost or diminished value of the wholesaler’s business.¹⁵⁸

5. Farm Implement and Heavy Equipment Dealers

The vast majority of states have also enacted legislation that governs the relationship between farm implement and heavy equipment dealers and manufacturers. These statutes generally use the term “supplier” to describe manufacturers, wholesalers, or distributors of farm

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¹⁵⁰ *Id.* at § 2805.

¹⁵¹ *Id.* at § 2801.

¹⁵² *Id.* at § 2802.

¹⁵³ *Id.* at § 2805.

¹⁵⁴ *Id.*

¹⁵⁵ See, e.g., Ohio Rev. Code § 1333.83 (2004) (stating that a franchise relationship is established if beer or wine is distributed for 90 days or more).

¹⁵⁶ See, e.g., Mich. Code Ann. § 436.1305 (2001).

¹⁵⁷ See, e.g., Iowa Code Ann. § 123A.5 (2007).

¹⁵⁸ See, e.g., Fla. Stat. Ann. § 563.022(17) (2003, pocket part 2009).

equipment and other heavy equipment. “Dealer” is typically defined as an individual who is involved in the retail sale of such farm and heavy equipment.

Again, the most commonly-litigated and utilized provisions of farm and heavy equipment acts are the provisions governing termination of the parties’ agreements. The majority of farm implement and heavy equipment dealer acts also require the supplier to provide a dealer with notice of its intent to terminate and an opportunity to cure any alleged defaults.¹⁵⁹

Grounds for immediate termination are very similar to grounds for immediate termination under state franchise relationship laws, including filing a petition for bankruptcy, defaulting under a security agreement between the dealer and the supplier, or a change in location of the dealer’s business without supplier’s approval.¹⁶⁰

Often, farm implement and heavy equipment dealer laws require that a manufacturer repurchase from a terminated dealer the dealer’s inventory of equipment and, in many cases, repair parts. Under some state statutes, the repurchase requirement only applies when a dealer is terminated without good cause.¹⁶¹ In other states, repurchase requirements apply in any situation when a dealer is terminated.¹⁶²

Failure to repurchase as required by state law usually results in civil liability, often for 100% of the current net price of the inventory, plus interest, costs and attorneys’ fees.¹⁶³

III. STRUCTURING TO AVOID FRANCHISE AND BUSINESS OPPORTUNITY LAWS

A. Alternative Relationship Models

If there was an easy way to avoid franchise laws altogether those laws would have been amended long ago to close up such loop holes. Nonetheless, many companies knowingly continue to try to avoid these laws. The franchise laws are perceived as cumbersome, costly to comply with, and causing delay in the sales process. The element of public disclosure of the franchisor’s business and finances connected with the registration of the franchise disclosure document is viewed as an additional downside to franchising.

Finding an alternative model to franchising will always be a fact-based inquiry without a one size fits all solution. Depending on the goal of the franchisor/licensor/manufacture, different models will be appropriate. The solution, if any, is likely to be quite different for the restaurant owner who is looking to let his brother-in-law in Arizona open up a “sister restaurant,” than it will be for the alternative fuel manufacturer who is looking to roll out his system throughout the entire U.S. In general, the “trick” is usually to avoid one or more of the elements that make up a franchise.

If the fee element, the market plan element or the trademark element can be avoided, there usually is no franchise.¹⁶⁴ Avoiding the elements of a franchise is often easier said than

¹⁵⁹ See, e.g., Kan. Stat. Ann. § 16-1204 (2007) (90 day notice and 60 day cure period).

¹⁶⁰ See, e.g., Mass. Gen. L. Ch. 93G, § 2(b) (2006).

¹⁶¹ See, e.g., Ohio Rev. Code Ann. §§ 1353.01-1353.05 (2004).

¹⁶² See, e.g., Md. Code Ann. Com. Law §§ 19-201 to 19-204 (2002, pocket part 2008).

¹⁶³ See, e.g., N.D. Cent. Code § 51-07-01, 51-07-03 (2008); Md. Code Ann. Com. L. § 19-305 (2002, pocket part 2008).

done, and, in the end, it may be more costly for the franchisor than the dollars initially saved by avoiding franchise disclosure.

Giving up the trademark license often defeats the very purpose of using a franchise-like distribution system both for the franchisor and the franchisee. The strength of franchising to a large extent lies in the customer's recognition of each unit being one of a network the customer is already familiar with, and that recognition mostly depends on trademark association. Because of the extremely low standards required for trademark association,¹⁶⁵ it may be very hard to avoid this element short of outright prohibiting the franchisee from using the franchisor's trademark in relation to customers. It is also easy for a franchisee to inadvertently use franchisors' trademarks.

Likewise, the assistance, control, marketing plan element is hard to eliminate. As discussed below, trademark laws make it hard for franchisors to allow franchisees free range with their licensed trademarks without jeopardizing the franchisors' trademark rights, yet too much control over the franchisees will squarely land them in franchise law territory. Also, there are many indicia that comprise this element and it is not always clear whether one has completely avoided it.

The easiest (but not bulletproof) way of avoiding franchise designation is to avoid the payment of a franchise fee. As discussed above, many different payments can be construed as a franchise fee, and a franchise system would have to truly commit to only charge a bona fide wholesale price for goods sold to the franchisee to avoid this element of the franchise definition. For many distribution systems, this may not be a palatable or practical solution.

1. Joint Ventures/Partnerships

Many franchisors have tried to avoid franchise laws by changing the vertical relationship between franchisor and franchisee into a (seemingly) horizontal relationship by having the "franchisor" and "franchisee" form a joint venture. Joint ventures can take many different shapes or forms,¹⁶⁶ but the simplest form is the general partnership, where the different partners each contribute something of value to the joint undertaking.¹⁶⁷ It is not unusual for a party with a good business idea, but without the necessary capital to bring its idea to market or expand the idea to a broader market, to seek investors to capitalize the business plan. Often, these investors will receive an interest in the business in exchange for their capital contribution. It may be counterintuitive that co-owners could be franchisor and franchisee respectively, but if the joint venture relationship is analyzed from a franchise law perspective, what the investor is buying is a franchise: the investment made for a share in the business is a fee; in exchange for that fee the investor likely gets the right to use a trademark; and the use of the trademark will be restricted by the business plan of the inventor/original business owner.

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¹⁶⁴ Note that business opportunity laws and sales representative laws may still be applicable and some states, such as New York, have unusually broad franchise definitions. In addition, as noted above, relationship statutes may still apply.

¹⁶⁵ See, e.g., the Minnesota statute discussed above.

¹⁶⁶ See Rochelle B. Spandorf and Mark A. Kirsch, *The Accidental Franchise*, American Bar Association 24th Annual Forum on Franchising, for a discussion of various types of joint venture arrangements.

¹⁶⁷ Other entity formats can also serve as a joint venture vehicle. Examples include corporations, limited liability companies and limited partnerships. General partnerships, however, have been granted a special status by being singled out for an exemption from the FTC Rule. The general partnership exemption is discussed below.

Under the Original FTC Rule, selling an ownership interest in a joint venture entity to another person could constitute the sale of a franchise. Whether this is still the case under the Amended FTC Rule is not clear. The basic definition of a "franchise" under the Original FTC Rule and the Amended FTC Rule is different in some respects, but contains the same, basic elements: there must be a continuing commercial relationship between the franchisor and franchisee; there must be a trademark license granted; the franchisor must exercise or have the right to exercise control or provide assistance to the franchisee; and a franchise fee must be paid. Nonetheless, the scope of the Amended FTC Rule may differ from the Original FTC Rule due to the difference between who is a "franchisee" under the Original and the Amended Rule. Under the Original FTC Rule the definition of a "franchisee" encompassed the "person (1) who participates in a franchise relationship as a franchisee ... or (2) to whom an interest in a franchise is sold."¹⁶⁸ A common scenario would involve a joint venture entity set up by the putative franchisor and the investor. The putative franchisor would grant the joint venture entity a license to use its trademark and system.¹⁶⁹ Under the Original FTC Rule, the sale to the investor of a share in the joint venture entity could fall under the Rule because the investor would fall under the definition of a "franchisee." Under the Amended FTC Rule, a "franchisee" is defined as "any person who is granted a franchise."¹⁷⁰ The reference to persons acquiring an interest in a franchise was intentionally done away with as the FTC recognized that the old definition arguably covered shareholders of publicly traded companies, as well as other investors.¹⁷¹ Using the same example as above, but applying the Amended FTC Rule, it is unclear how to apply the Rule: The franchisee would be the joint venture entity, not the investor, so the franchise relationship could only be between the franchisor and the entity.¹⁷² The purchase by the investor of an interest in the joint venture entity does not squarely fit within the franchise definition of the Amended FTC Rule. Other comments made by the FTC, however, indicate that a sale of an interest in a joint venture is still likely to be within the purview of the Rule. Under the Original FTC Rule several types of relationships, including general partnerships, were excluded from the scope of the Rule.¹⁷³ While the FTC deleted these exclusions from the Amended FTC Rule, it specifically maintained the viability of the exclusions in the Statement of Basis and Purpose of the Amended FTC Rule.¹⁷⁴ If franchise relationships structured as joint ventures were intended to be excluded from the scope of the Amended FTC Rule, there would be no need to retain the general partnership exclusion since a general partnership would be one of the types of joint venture entities already excluded from the scope of the Rule.¹⁷⁵ Until further guidance from the FTC or the courts on the implications of the

¹⁶⁸ The Original FTC Rule 16 C.F.R. § 436.2(d) (1979).

¹⁶⁹ Given Informal Staff Advisory Opinion 98-5 (discussed below), which considers the franchisor's right to earn a share of the profits of a joint venture entity as a franchise fee, it probably is not relevant whether the license agreement is royalty-free or requires royalty payments, as long as the franchisor receives a share of the profits from the business.

¹⁷⁰ The Amended FTC Rule, 16 C.F.R. § 436.1(i) (2007).

¹⁷¹ The New Statement of Basis and Purpose, released January 23, 2007, 72 FR 15460, Bus. Franchise Guide (CCH) ¶ 6050.

¹⁷² If the transaction would be considered a franchise sale, and the joint venture entity the franchisee, it appears the FTC Rule disclosure obligation could, at least technically, be satisfied by the franchisor disclosing only itself (in its capacity as one of the owners of the joint venture entity), since the Amended FTC Rule no longer requires that all partners or owners of the prospective franchisee be disclosed. See, Federal Trade Commission, *Franchise Rule Compliance Guide*, at 18. However, the FTC is likely to take a dim view of such a practice.

¹⁷³ The Original FTC Rule, 16 C.F.R. § 436.2(a)(4) (1979).

¹⁷⁴ The Statement of Basis and Purpose for the Amended FTC Rule, 72 Fed. Reg. 61, 15530 (March 30, 2007), Bus. Franchise Guide (CCH) ¶ 6050.

¹⁷⁵ Of course, there is no specific discussion of joint ventures in the Statement of Basis and Purpose or the FTC Franchise Rule Compliance Guide.

revised scope of the Amended FTC Rule, it would be dangerous to assume that the Rule can be avoided in all instances by structuring a distribution system as a series of joint venture entities.

At the time of writing, parties contemplating a joint venture arrangement in lieu of a franchise, but concerned about the applicability of the FTC Rule to the relationship could consider structuring the joint venture as a general partnership fitting within the scope of the general partnership exemption. The general partnership exclusion does not automatically exclude all general partnerships from the scope of the FTC Rule. It will always be a question of fact. Whether a particular relationship falls within the FTC Rule hinges on the nature of the relationship between the partners. In a true partnership, the partners exercise control over each others' conduct.¹⁷⁶ In a franchise relationship, the franchisee would not have much control over the franchisor's conduct. If a joint venture general partnership resembles a franchisor-franchisee relationship rather than a true partnership, it may fall under the Amended FTC Rule in spite of the general partnership exemption from the Rule. The FTC has also made clear that the exclusion does not apply where the partnership is a limited partnership, and the "franchisor" is the limited partner, since it perceives that as giving the franchisor an unfair advantage over the franchisee/general partner.¹⁷⁷

The FTC Informal Staff Advisory Opinion 98-5 includes an illustrative example of how the FTC analyzes joint ventures. The requestor wanted to start a system where each investor would form a corporation of which the investor would be the majority owner. The investor would be responsible for the operations of the corporation's business. The requestor would be the minority owner and it would license its trademark to the corporation and would also provide support and controls to the corporation. Under the license agreement, there would be no payments due for the first six months of operations, and there were no other direct payments made by the investor to the requestor. Nonetheless, the FTC found that the requestor/franchisor's right to receive a share of the profits from the business equated to a royalty payment under a franchise agreement and could be considered a franchise fee, thereby making the arrangement subject to the FTC Rule.

In spite of the question of scope of the Amended FTC Rule, joint ventures must be very carefully structured if the parties want to avoid federal franchise laws. The partnership must be general and not limited. The division of responsibilities and powers must also be structured so that the relationship is a general partnership in fact. If the business owner or inventor is willing to part with this much control over its trademark and system and willing to be subject to the fiduciary duties that partners have towards each other, the general partnership model may be a good option. To the extent the operations of the general partnership will be in a state which regulates franchises, the parties must ensure that state law contains a similar exclusion.

2. True License Arrangements

In a true license arrangement, while the trademark or other intellectual property licensed is at the heart of the agreement, and there is a fee being charged for the right to use the intellectual property, the restrictions on how the licensee can use the intellectual property are limited to quality control of the intellectual property. The licensor's limited control over the licensee's business is thus the primary distinguishing factor between a franchise and a license. It is a fine line to walk: too much control will render the relationship a franchise and too little

¹⁷⁶ 43 Fed. Reg. 246, 59709, (December 21, 1978).

¹⁷⁷ 43 Fed. Reg. 246, 59709, (December 21, 1978). So far, there is no guidance from the FTC on whether a limited liability company, which is usually considered a partnership for federal income tax purposes, could qualify for the general partnership exclusion.

control may lead to a forfeiture of the licensor's rights in the trademark. Under the federal Lanham Act, if a trademark owner allows a third party to use its trademark without controlling that use (a so-called "naked" license), the trademark may be deemed abandoned, and the licensor may lose its rights in the trademark. From a franchise law perspective, very little control is necessary to satisfy the "marketing plan" element of the franchise definition, and it is not even necessary that the franchisor exerts control over the franchisee as long as it has the right to do so.¹⁷⁸

Notwithstanding these limitations, for a small business that has been approached by its first prospective franchisee, licensing may be a good solution. The FTC recognizes a single trademark license exemption under the Amended FTC Rule. The difference between a trademark license and a franchise, for purposes of the FTC Rule, is the degree of control that the licensor or franchisor exercises over the franchisee/licensee. A licensor is more interested in the outcome—the final goods that the licensee manufactures—than in the process. Simply put, "the license conditions and restrictions [must be] reasonably tailored to preserving the integrity of licensor's mark."¹⁷⁹ Going beyond that level of control, the control becomes akin to that under a franchise agreement falling outside of the exclusion. A franchisor cares not only about the final good or service, but also cares about the process and imposes its marketing plan or system on the franchisee for that reason. The kind of control that a licensor would exercise is often referred to as "passive" control. When the control imposed by the licensor covers methods of operation and is significant, it is no longer a license agreement, but a franchise. By reference to the Statement of Basis and Purpose for the Original FTC Rule, the FTC has continued the single license exemption in the Amended FTC Rule.

Considering the potential for abuse of the single license exclusion, the FTC allows licensors more leeway than may be expected within the framework of the "single" license exemption. For example, if a licensor and one licensee enter into a license agreement for multiple locations, the single trademark license exemption still applies. The same is true where a licensor enters into a license agreement with one licensee and then wishes to enter into additional license agreements for additional locations with the same licensee. Those additional license agreements could still fall within the single trademark license exemption.¹⁸⁰

There are several issues the licensor needs to be aware of in relying on the single trademark exclusion. To the extent the license will involve franchise registration/relationship states, the licensor must determine if the license agreement falls within the franchise definition of the states involved. Unless the agreement falls outside of all applicable statutes, the licensor may be subject to the disclosure and registration requirements of the state. Even if the license agreement is not subject to state registration and disclosure laws, termination or non-renewal of the license agreement may be subject to state relationship laws.

Also, the licensor should consider the long-term effects on growing its system that may stem from entering into a license arrangement in the early stages of system development. If the initial license agreement goes well, and the licensor later desires to expand its business through a true franchise arrangement, it will have to decide how the single licensee will fit into the franchise system. The terms of that first license agreement are often times quite different from what the terms of a desired franchise agreement may be. One tempting approach could be to include provisions in the license agreement that would permit or require the licensee to convert

¹⁷⁸ See, e.g., *RJM Sales & Mktg., Inc. v. Banfi Products Corp.*, 546 F. Supp. 1368, 1374 (D. Minn. 1982); Bus. Franchise Guide (CCH) ¶ 7905.

¹⁷⁹ FTC Informal Staff Advisory Opinion 05-1.

¹⁸⁰ FTC Informal Staff Advisory Opinion 02-1.

its license agreement to a franchise agreement if the licensor later decides to start a franchise system. However, under the Original FTC Rule, the FTC has equated the sale of an option to purchase a franchise to the sale of a franchise, and it is not clear whether the Amended FTC Rule changes that interpretation.¹⁸¹

3. True Distributorships

A distributorship is a relationship where the distributor purchases goods from the manufacturer at the bona fide wholesale price and then distributes the goods to retailers or the public. Distributorships can often be similar to franchise relationships. The manufacturer may award the distributor an exclusive territory or exclusive sales channels; the distributor is often expected to align its business to some extent with that of the manufacturer and hold itself out in a more or less extensive way as related to the manufacturer; and it is not uncommon for the distributor to be prohibited from selling competing brands of goods. There may be minimum sales requirements tied to the distributor's right to continue as the manufacturer's distributor, or those requirements may have to be met in order to maintain exclusivity. While there are similarities between distribution agreements and franchise agreements, there are also important distinctions. A distributor will usually clearly hold itself out to be known to the general public as an independent business and will have more control over how it operates its own business than the typical franchisee. However, with the trademark element and the marketing plan element of many statutory franchise definitions being vague and easily satisfied, the distributor's independence alone may not be enough to distinguish it from a franchisee. The real difference between a true distributorship and a franchise is the absence of a franchise fee in the distributorship relationship.

To avoid franchise laws, once the distributor has paid for the goods it distributes which price must be a bona fide purchase price, there should be no further payment obligation to the manufacturer. If there is truly no other payments going from the distributor to the manufacturer, this type of relationship would not be a franchise, even if there is trademark association between manufacturer and distributor, and if there is a marketing plan that the distributor must follow.

If the manufacturer is content with the remuneration that comes from the sale of the goods to the distributor, this may be a viable alternative to franchising. The temptation that exists, however, is to try to extract additional money from the distributor for the right to use the trademark and system or sometimes just for little extras that the manufacturer provides to the distributor. For example, maybe the distributor could be required to pay for marketing materials that they will have to purchase; or maybe the distributor will be required to purchase additional goods above what they are expected to sell. To avoid franchise law applicability, the answer to both these suggestions must usually be: No. As discussed above in the section on franchise fees, the payment of many minor fees, when added up, may exceed the minimum payment threshold and trigger the franchise fee element. The FTC Compliance Guide states that the terms "fee" or "payment" should be broadly understood and lists many different types of payments that satisfy the requirement (assuming they exceed \$500): initial franchise fee, rent, advertising assistance, equipment and supplies, training, security and escrow deposits, bookkeeping charges, promotional literature, equipment rental, and continuing royalties on sales.¹⁸² The FTC Compliance Guide also makes clear that payments for reasonable amounts of inventory do not constitute a fee under the FTC Franchise Rule.

¹⁸¹ FTC Informal Staff Advisory Opinion, *Real Am. Estate Corp.*, April 9, 1982.

¹⁸² Federal Trade Commission, *FTC Compliance Guide*, at 5.

The manufacturer who sets up a distribution system relying solely on the bona fide wholesale exemption, but who imposes controls over its distributors, should be aware that the distribution system will not exempt from all franchise legislation. In Connecticut, for example, the franchise relationship statute defines a franchise by only two elements: the existence of a trademark license and a marketing plan, and the absence of franchise fees will be irrelevant.¹⁸³ Likewise, some of the state relationship laws will apply to the relationship.¹⁸⁴ Likewise, the distribution agreement may be subject to business opportunity laws and industry specific franchise laws.

The difficulty of avoiding franchise laws through distributorship arrangements is highlighted in several recent cases.

In *Emergency Accessories & Installation, Inc. v. Whelen Engineering Co., Inc.*,¹⁸⁵ the parties had entered into a "Master Distributor Agreement," under which the distributor could use the manufacturer's trademark, had to maintain a full-time sales force, and was otherwise to use its best efforts to promote the manufacturer's products. Sales of the manufacturer's products accounted for over fifty percent of the distributor's business, and it carried up to \$1,000,000 in inventory of the products at any time. The manufacturer tried to terminate the Master Distributor Agreement, and the distributor resisted. On a motion for injunctive relief, the U.S. District Court for the District of New Jersey found that the distributor had met its burden of proof for a temporary restraining order based on the manufacturer's alleged breach of the New Jersey Franchise Practices Act.

In an effort to avoid disclosing an 8-year old felony conviction, the defendants in *FF Orthotics, Inc. v. Paul*¹⁸⁶ decided, on the advice of their attorney, to structure their distribution system as a dealership instead of a franchise. While the appellate opinion is sparse with respect to the actual terms of the dealership agreement, the agreement appears to have granted the dealers exclusive territories, limited their rights to compete with the manufacturer's products, and required the dealers to carry the full line of manufacturer's products. Additionally, the manufacturer controlled advertising. At trial, the jury found that the manufacturer had breached the California Franchise Investment Law.¹⁸⁷

IV. CONSEQUENCES OF NON-COMPLIANCE

A. Litigation

1. Statutes

a. FTC Franchise Rule

The Federal Trade Commission has the authority and responsibility for prosecuting violations of the FTC Rule. The FTC is charged with enforcing the Amended FTC Rule under Sections 5, 13(b) and 19 of the FTC Act.¹⁸⁸ Under Section 13(b) (15 U.S.C. § 53(b)), the FTC

¹⁸³ See, e.g., *Hillegas v. V.B.C., Inc.*, No. CV074007774S., 2007 WL 3173462 (Conn. Super. Oct. 15, 2007).

¹⁸⁴ See, e.g., the Wisconsin Fair Dealership Act, Wis. Stat. § 135.01 et seq., Bus. Franchise Guide (CCH) ¶ 4490.01 et seq.

¹⁸⁵ *Emergency Accessories & Installation, Inc. v. Whelen Eng'g Co., Inc.*, Civil Action No. 09-2652 (JEI/AMD), 2009 WL 1587888 (D. N.J. June 3, 2009).

¹⁸⁶ *FF Orthotics, Inc. v. Paul*, No. D044226, 2006 WL 1980270 (Cal. App. July 17, 2006).

¹⁸⁷ *FF Orthotics, Inc.* at *2. The appellate court, however, overturned the jury verdict since the claims brought were in part time barred and in part refused to apply CFIL extraterritorially.

¹⁸⁸ Amended FTC Rule, 16 C.F.R. § 436.6(a) (2007).

can seek preliminary and permanent injunctions to remedy “any provision of law enforced by the Federal Trade Commission.” Under 15 U.S.C. § 57(b), a court can grant rescission and also monetary damages for purposes of providing consumer redress. Finally, section 15 U.S.C. § 45(m)(1)(A) allows the FTC to also seek civil penalties of \$11,000 per violation of the Rule.

Additionally, while courts have consistently held that the FTC Rule does not provide a private right of action, a court may look to the FTC Rule as prescribing upon the franchisor an obligation to disclose, as well as the standard of disclosure, in a common law fraud case to determine whether the franchisor failed to provide the franchisee with material information.¹⁸⁹

b. State Franchise Statutes

The remedy provided by state franchise acts generally varies depending on whether the violation of the act is based on fraud/pre-sale disclosure violation or a wrongful termination.

Pre-Sale Violations

Generally, state franchise acts allow an injured franchisee to seek actual damages, and/or injunctive relief and, often times, its reasonable attorneys’ fees and costs. Additionally, some statutes provide for double or treble damages for the violation.¹⁹⁰ Many statutes expressly provide that the franchisee may seek rescission of the franchise agreement. Rescission is the unwinding of the actual franchise agreement and restitution is the remedy which provides for the recovery of damages. The purpose of rescission and restitution is to restore the franchisee to its pre-contractual position.

Rescission of a contract is an appropriate remedy if there has been a material misrepresentation of fact upon which a party relied and which caused it to enter the contract ... Rescission, simply stated, is the unmaking of a contract. It is a renouncement of the contract and any property obtained pursuant to the contract, and places the parties, as nearly as possible, in the same situation as existed just prior to the execution of the contract. A condition precedent to rescission is the offer to restore the other party to its former condition as nearly as possible.¹⁹¹

Some courts take very seriously the condition precedent that the party seeking rescission must offer to restore the other party to its pre-contractual position. In *The Final Cut, LLC v. Sharkey*,¹⁹² the Superior Court of Connecticut struck a claim for rescission and a prayer for rescission and restitution where the plaintiff failed to allege facts supporting that the plaintiff offered to restore the defendant to its pre-contractual position.

Courts also differ in terms of how to restore the franchisee to its pre-contractual position. In the pro-franchisee case of *Young v. T-Shirts Plus, Inc.*, the Court of Appeals of Wisconsin held that the franchisee was entitled to not only recover operating losses, but also lost wages (subject to offsets for any income or profit received as the result of the franchise).¹⁹³ Contrary to the approach taken in *Young*, some courts approach restitution damages as awarding the plaintiff only the benefits conferred upon the other party (and not reliance damages due to

¹⁸⁹ *Rodopoulos v. Sam Piki Enterprises, Inc.*, 570 So.2d 661 (Ala 1990).

¹⁹⁰ See, e.g., Hawaii Stat. Ann. § 482E-9(d).

¹⁹¹ *The Final Cut, LLC v. Sharkey*, No. FSTCV2009 WL 1532281, at *4 (Conn. Super. Ct. May 5, 2009) (quoting *Paul Revere Life Ins. Co. v. Pastena*, 725 A.2d 996, cert. denied, 734 A.2d 567 (2005)).

¹⁹² *Id.* at 4-5.

¹⁹³ 349 N.W.2d 109 (Wis. App. 1984) (unpublished opinion).

monies expended and paid to third parties).¹⁹⁴ When a court takes the approach that restitution is limited to the benefit conferred on the other party, a franchisee can seek to recover its operating losses and monies paid to third parties as a result of the franchise agreement as “consequential damages” or “other relief” provided for in the statutes.¹⁹⁵

In addition to private actions for rescission and restitution, state registration and disclosure laws often grant state officials the right to restrain franchisors from taking actions in violation of state statutes, or to suspend the franchisor’s right to sell franchises in the state.¹⁹⁶ Further, statutes often provide for civil penalties and criminal prosecution of franchisors that fail to comply with registration and disclosure violations.¹⁹⁷

Relationship/Termination Violations

Generally, state franchise relationship laws provide for injunctive relief and/or compensatory damages and often provide for recovery of reasonable attorneys’ fees and costs. A franchisee who has been wrongfully terminated can sue for lost profits and lost business value (but not both usually because the damages are duplicative). Treble damages may also be available in some state franchise acts. State relationship statutes may also impose buy-back obligations on franchisors/manufacturers if the franchisor/manufacturer violated the statute and, sometimes, even if the franchisor/manufacturer complied with the statute.¹⁹⁸

Lost profits is the most common mechanism for proving damages for a violation of a relationship statute. If the dealer has a profit record established prior to the violation, the dealer’s profit record prior to the violation is compared to the dealer’s profit record following the violation.¹⁹⁹ If the business is too new to have a clearly established profit record, a “yardstick” study is done of business profits of a closely comparable business.²⁰⁰ A lost profits analysis is the appropriate mechanism for determining damages when the statutory violation results in a loss of line rather than the entire business. In *Buono Sales, Inc. v. Chrysler Motors Corp.*, the court held that, where there was a loss of a line and not complete destruction of the business, and overhead or fixed expenses were not affected by defendant’s breach of agreement, no deduction should be made for them in calculating profits which plaintiff would have made had it not been for the breach.²⁰¹

If the entire business is destroyed or nearly destroyed, the proper measure of damages is the loss of business value, which is equal to the change in worth of the going concern after the statutory violation.²⁰² Business goodwill and future profits are computed into the “going concern” value loss.²⁰³

¹⁹⁴ See *DeRosa v. Boston Bakery & Italian Food Specialty, Inc.*, 98 B.R. 644 (D. R.I. 1989) (distinguishing between restitution and reliance damages).

¹⁹⁵ *Brader v. Minute Muffler Installation, Ltd.*, 914 P.2d 1220, 1223 (Wash. App. 1996) (declining to address the particular issue, but noting the potential availability of business losses under the “other relief” provision of the Washington Franchise Investment Protection Act).

¹⁹⁶ See, e.g., 815 Ill. Comp. Stat. § 705/22 (2008); Wash. Rev. Stat. Ann. § 19.100.210 (1999, pocket part 2009).

¹⁹⁷ See, e.g., 815 Ill. Comp. Stat. § 705/24, 715/25 (2008); Wash. Rev. Stat. Ann. § 19.100.210 (1999, pocket part 2009).

¹⁹⁸ E.g., Wis. Stat. § 135.045 (2009).

¹⁹⁹ *C.A. May Marine Supply Co. v. Brunswick Corp.*, 649 F.2d 1049, 1053 (5th Cir. 1981).

²⁰⁰ *Id.*

²⁰¹ 449 F.2d 715, 720 (3d Cir. 1971).

²⁰² *Id.*

²⁰³ *Id.*

c. Little FTC Acts

Unlike the FTC Act, many state enacted consumer protection/unfair and deceptive trade practices acts do provide franchisees with a private right of action. Remedies vary from state-to-state, but, generally, they provide for actual damages and/or injunctive relief and attorneys' fees and costs, as well as, in some cases, double or treble damages.²⁰⁴ Furthermore, under some little FTC Acts, control persons can also be subject to liability if the person is a direct participant in the actions that constitute the violation.²⁰⁵

d. Business Opportunity Statutes

Like the FTC Rule on franchising, the FTC Rule on business opportunities²⁰⁶ provides the FTC with the authority and responsibility for prosecuting violations, pursuant to Section 5, 13(b) and 19 of the FTC Act. Under Section 13(b), the FTC can seek preliminary and permanent injunctions to remedy. Under 15 U.S.C. § 57(b), a court can grant rescission and also monetary damages for purposes of providing consumer redress. Section 15, U.S.C. § 45(m)(1)(A) establishes civil penalties of \$11,000 per violation of the Rule.

As with the FTC Rule on franchising, there is no private right of action for violations of the business opportunity Rule, but a court may use the FTC Rules to prescribe upon the franchisor an obligation to disclose, and the standard of disclosure, in a common-law fraud case to determine whether the franchisor failed to provide the franchisee with material information.

Business opportunity statutes generally offer two types of civil remedies for their violation: rescission and recovery of actual damages. Many state laws allow a purchaser that has been wronged by a violation of a business opportunity statute to rescind the business opportunity contract upon written notice to the seller within one year of the date of the contract.²⁰⁷

A rescinding purchaser may recover any money and other valuable consideration paid to the seller in exchange for the business opportunity.²⁰⁸ Generally, the statutes require that a rescinding purchaser return all equipment or other items received from the seller in order to obtain a refund of consideration paid.

Many business opportunity statutes also provide for recovery of actual damages, costs and attorneys' fees.²⁰⁹ In California, the actual damages must be at least the amount of the purchaser's initial investment, and courts may award punitive damages.²¹⁰ The Illinois statute allows for recovery of treble damages when the seller has violated the provisions of the statute prohibiting misrepresentations or fraudulent practices.²¹¹ Business opportunity laws that require

²⁰⁴ See, e.g., Cal. Bus. & Prof. Code § 17082 (2008).

²⁰⁵ *KC Leisure, Inc. v. Haber*, 972 So.2d 1069, 1074 (Fla. Dist. Ct. App. 2008).

²⁰⁶ 16 C.F.R. § 437.1, effective July 1, 2007; 72 Fed. Reg. 15444, March 30, 2007.

²⁰⁷ See, e.g., Fla. Stat. Ann. § 559.813 (2006); Ga. Code Ann. § 10-1-417 (2003, pocket part 2008); 815 Ill. Comp. Stat. § 602/5-210 (2008); Ind. Code § 24-5-8-16 (2005); Neb. Rev. Stat. § 59-1752 (2006); S.D. Codified L. § 37-25A-48 (2009).

²⁰⁸ See, e.g., Ga. Code Ann. § 10-1-417; 32(2003, pocket part 2008); Me. Rev. Stat. Ann. § 4700 (1999); Neb. Rev. Stat. § 59-1752 (2006).

²⁰⁹ See, e.g., Fla. Stat. Ann. § 559.813 (2002); Cal. Civ. Code § 1812.218 (2009); Ind. Code § 24-5-8-17 (2006); 32 Me. Rev. Stat. Ann. § 4700 (1999).

²¹⁰ Cal. Civ. Code § 1812.21 (2009).

²¹¹ 815 Ill. Comp. Stat. § 602/5-120 (2008).

the furnishing of a bond or establishment of a trust account also provide a method of making claims against the bond or account.²¹²

Some business opportunity statutes provide that a violation of their provisions amounts to a violation of other state statutes, such as unfair and deceptive trade practices laws.²¹³ Many also contain provisions specifically stating that a party injured by violations of the business opportunity act's provisions is entitled to remedies available under other statutes or the common law, in addition the remedies available under the business opportunity law.²¹⁴

Under the state statutes, violations also are typically criminal acts. A violation may constitute a felony,²¹⁵ or a misdemeanor.²¹⁶

B. Effect on System and Growth

Apart from the immediate consequences of a violation of franchise laws described above, a prospective franchisor must be mindful of the potential long-term consequences that such breaches may have. If a system has been operated without regard to franchise laws applicable to it, this fact will be hard to hide, once a true franchise program is developed. For example, state examiners usually require disclosure of the prior distribution arrangements; and often will refuse to register the franchise unless and until the franchisor stipulates to a cease and desist, or similar order, pays a civil fine and in many cases offers rescission to the putative franchisees; litigation with putative franchisees and government orders must often be disclosed in Item 3 of the franchise disclosure document; and settlement agreements concerning the putative franchisees may have to be discussed in some detail in Item 13. These types of disclosures may raise doubt in the minds of prospective franchisees about how the franchisor operates its business.

V. CONCLUSION

A company contemplating growing its business through a distribution system of any kind must carefully review both state and federal franchise and business opportunity laws. If avoiding all regulation is a goal, the company must expect to be severely limited in its structuring options.

Failure to comply with the statutes discussed in this article may have both direct and indirect consequences. The direct consequences include fines, damages, and grant of rescission rights to the franchisees. The indirect consequences that could result include having to disclose prior illegal franchise sales in future franchise disclosure documents, and a tarnished public image of the company.

²¹² See, e.g., Alaska Stat. § 45.66.120(a).

²¹³ See, e.g., Ga. Code Ann. § 10-1-417 (2003, pocket part 2008).

²¹⁴ See, e.g., 32 Me. Rev. Stat. Ann. § 4700 (1999); Neb. Rev. Stat. § 59-1752 (2006); S.D. Codified L. § 37-25A-53 (2009).

²¹⁵ See, e.g., Alaska Stat. § 45.66.210(a) (2009); Fla. Stat., Ch. 559 § 559.815 (2006); and Ind. Code tit. 24, Art. 5, Ch. 8, § 19 (2006).

²¹⁶ See, e.g., Alaska, *supra*.

Exhibit - Federal and State Franchise Law Exemptions or Exclusions

JURISDICTION	ORAL CONTRACTS	MINIMUM PAYMENT AMOUNT	FRACTIONAL FRANCHISE	RETAILER LICENSE (LEASED DEPARTMENT)	EMPLOYEES	GENERAL PARTNERSHIPS	COOPS	CERTIFICATION MARKS	SINGLE LICENSE	LARGE FRANCHISOR	SOPHISTICATED PURCHASER/EXPERIENCED FRANCHISEE	ISOLATED OR LIMITED SALES	SALE BY FRANCHISEE	OUT OF STATE SALES	PETROLEUM WHOLESALERS	SALES BY EXECUTOR, TRUSTEE, ETC.	BANK CREDIT CARD PLAN	BANKS	MOTOR VEHICLES	RENEWAL W/O CHANGE	SALE TO EXISTING FRANCHISEE	OTHER
FTC		X	X	X	SB P		SB P	SB P	SB P		X				X							X
CA		R	X				X			X	X		X	X	X		X					
HI													X	X		X		X	X	X	X	X
IL		X	X	X			R*	X		R	R	R	X	X				X		X		R
IN			X							X		X	X									R
MD		R								R	R		X	R		X		R			X	
MI		X	X	X			X						X	X		X		X		X	X	X
MN		X	X	X								X	X	X		X		X	X			X
NY		X								X		X	X					X				R
ND										X			X									
OR		X	R	R	R	R	R	R	R				R							R	R	R
RI		X		X						X	X		X	X		X				X	X	X
SD			X	X									X			X		X				X
VA	X	X	X	X						R			R					R			R	
WA		X								X	X		X			X		X			X	X
WI		R	X				X				X		X	R				R			R	X R

Code:

“X” is statutory exemption. “R” is regulatory exemption. *Exemption from registration and disclosure requirements only.

“SBP” is Statement of Basis of Purpose of Amended FTC Rule.

Note: Some exemptions or exclusions avoid the need to comply with both the disclosure and registration obligations under the franchise laws. Others may only avoid the need to register or go through the state review process.

Kenneth R. Costello

Kenneth R. Costello is a partner in the Los Angeles office of Bryan Cave, LLP. He has 30 years experience in U.S. and international franchise and intellectual property law. He has written and spoken extensively on domestic and international franchising issues. Among many other publications, he co-authored "Franchising Law: Practice and Forms", a leading 3-volume treatise published by Specialty Technical Publishers.

He has served on the International Franchise Association's Supplier Forum Advisory Board, and on its Legal Legislative and Membership Committees, as an Articles Editor on the ABA *Franchise Law Journal* and on the Leader's *Franchising Business & Law Alert* Advisory Board. He has testified on franchise trade regulation issues before the Federal Trade Commission and has been consulted on franchising issues by the *Wall Street Journal*, *Reuters*, *New York Times*, *Los Angeles Times*, *Advertising Age*, *Entrepreneur*, *CBS News*, *Forbes*, *Nations Restaurant News*, among other media.

Mr. Costello is certified as a Franchise & Distribution Law Specialist by the State Bar of California; has been recognized as among the top 20 "Most Highly Regarded" franchise lawyers globally by *International Who's Who of Franchise Lawyer's* (Law Business Research, Ltd., London), by Chambers USA, Chambers Global, Best Lawyers In America, as a franchise "Super Lawyer" (by Law & Politics), and on the Franchise Times "Legal Eagle" list of top US franchise lawyers.

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Before joining Sonnenschein, Ms. Krakus practiced in Sweden and Poland with the Swedish law firm Magnusson Wahlin. She holds two law degrees: a degree (juris kandidat examen) from Stockholm University in Sweden, as well as a degree (J.D. *Cum Laude*) from Loyola University of Chicago, School of Law. Ms. Krakus has both spoken and written on various franchise law matters. Her most recent article, *Do Franchise Agreements Without Formal Expiration Dates Continue in Perpetuity?*, appeared in the Franchise Law Journal Spring 2009 issue.

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