Franchising 101

Key Issues in the Law of Franchising

By Susan A. Grueneberg and Jonathan C. Solish

Franchising has come of age. According to the International Franchise Association's website, franchising in the United States creates 21 million jobs at 900,000 locations nationwide and contributes $2.3 trillion in economic output annually. Franchisees have the advantage of independent ownership, with the assurance of goodwill generated by a network of businesses and the availability of assistance if the business runs into trouble. Franchisors can expand their concepts more quickly with reduced capital expenditure as their successes are fueled by the motivation brought by independent franchisee entrepreneurs.

What Is a Franchise?

It does not matter what label the parties put on a transaction or agreement: license, joint venture, consulting and supply agreement, dealership; if an arrangement has all of the elements of a franchise, it's a franchise. Scores of articles have been written about the dangers of becoming an accidental franchise. Those dangers are real, as many have learned when they face an unexpected regulatory enforcement investigation, or a lawsuit by a terminated licensee claiming the protection of franchise laws, or a major glitch in the sale of a company when the buyer's due diligence uncovers a possible unregistered franchise program.

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There are three main elements of the definition of a franchise under federal law and most state franchise laws.

Substantial Association with Trademark. The business must be substantially associated with the franchisor's trademark or other commercial symbol for the business to be a franchise. This usually takes the form of a license to use the franchisor's name. Because franchise laws were enacted to remedy perceived abuses in the treatment of franchisees, courts will often interpret those laws broadly. One California court found that there was substantial association with a company's trademark even though its use was prohibited and the mark was never communicated to the customers of the business. The contract between an operator of an office building employee cafeteria and its licensor involved substantial association with the licensor's trademark because the property owner was familiar with the reputation of the licensor, and that, the court found, was sufficient to render the contract a franchise agreement.

Payment of a Fee. A payment by a franchisee does not have to be labeled a franchise fee to satisfy this element of the definition. Ongoing royalty payments or payments characterized otherwise, such as consulting fees, training fees, or site assistance fees, are sufficient, as long as they are for the right to operate the business. Many of the state laws have de minimis exemptions for fees that total insignificant amounts. The FTC's Franchise Rule exempts payments of less than $500 during the first six months of operations. Some laws can be less clear, resulting in findings of franchises in unexpected situations. In one puzzling case, the required ongoing purchases of sales and service manuals by a franchisee that exceeded the state's de minimis threshold over a 20-year relationship resulted in a finding that a franchise had been created.

Each of the franchise laws exempts payments for goods for resale if the purchaser pays a bona fide wholesale price and if the purchaser is not required to purchase more than an amount that a reasonable businessperson would for his or her inventory.

Marketing Plan/Community of Interest/Significant Control. Most states follow California's lead and adopt as a third element a requirement that a franchisor prescribe a marketing plan in substantial part. Whether or not a marketing plan is present is a fact-driven analysis: Does the licensor provide promotional materials? Is there an operations manual? Does the licensor provide training that must be completed to its satisfaction? Is the putative franchisee free to make most decisions without first obtaining the licensor's consent? The types of controls that the licensor exerts must be substantial, and not just with respect to a small part of the business.

Some states employ a somewhat different standard: the parties must have a community of interest in the operation of the business. This concept is difficult to define with precision. At a minimum, there must be a continuing financial interest between the parties and they must be interdependent. Factors that are salient in determining whether a community of interest exists include the length of time the parties have been involved with one another; the extent and nature of their obligations; the relative amount of time and revenue attributable to the licensor's products or services; the percentage of revenues received from the licensor's products or services; any territorial grant; the use of the licensor's trademarks by the putative franchisee; the investment in inventory, facilities, and goodwill; the proportion of the putative franchisee's personnel that work on this part of the business; advertising expenditures for the licensor's products or services; and the extent of any supplemental services.

The FTC uses yet another standard: whether or not the licensor can exert significant control over the putative franchisee's method of operating the business, or whether significant assistance is offered in the method of operation.

Unusual Definitions. A few states, such as New York, have adopted a different type of definition. New York requires that only two elements be satisfied: the franchise fee element and either the trademark element or the marketing plan element.

Regulation of Franchising

Regulation of the offer and sale of franchises was ushered in by the adoption of the California Franchise Investment Law in 1970. A number of states followed California's lead, requiring pre-offer and sale disclosure as well as registration of franchise offers. The Federal Trade Commission (FTC) also promulgated a rule regulating franchises and business opportunities that became effective in 1979.

The FTC Franchise Rule. The FTC Rule mandates disclosure, but not registration.

For years, the FTC's disclosure format took a back seat to the disclosure format developed under the aegis of the North American Securities Administrators Association (NASAA) and its predecessor by states regulating franchising. The Uniform Franchise Offering Circular Guidelines was the disclosure format of choice, and disclosure documents were referred to as UFOCs. The FTC accepted the UFOC Guidelines format as an alternative to the format set forth in the Rule itself. After the FTC conducted a 12-year rule review process concluded in 2007, the FTC adopted the UFOC Guidelines format with some additions and updates. Since then, the FTC Rule format has become the standard. Franchisors' disclosure documents are now referred to as franchise disclosure documents or FDDs.

State Registration and Disclosure Laws. Fifteen states have enacted laws that regulate franchising. These laws range from requiring filing of an annual notice to a full-fledged review of a franchise registration application and a renewal registration application on an annual basis. The states that have enacted laws that regulate the offer and sale of franchises are California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Oregon, like the FTC, requires disclosure but not registration.

State Relationship Laws. The FTC Rule and the initial wave of state franchise statutes addressed presale disclosure to franchisees. Subsequently, 16 states have passed "relationship laws" focused on the rights of franchisees in existing franchise relationships. There are also other state statutes, in these and other states, that address specific industries, most notably petroleum dealers, automobile dealers, farm equipment dealers, and alcoholic beverage distributorships.

Relationship laws were passed to restrict the power of franchisors over franchise terminations, renewals, transfers, and certain other aspects of the franchise relationship. The statutes generally apply to franchisees located within a particular state, although coverage of state relationship laws may vary. State relationship laws usually require good cause for termination, which is defined as a material breach of the franchise agreement. State laws often impose a requirement of a notice of default and an opportunity to cure.

These statutes also can restrict a franchisor's right to refuse to consent to a transfer by the franchisee to situations in which the franchisor has good cause. They often make it unlawful for a franchisor to interfere with franchisees' right to form a franchise association. Five states—Hawaii, Illinois, Indiana, Minnesota, and Washington—prohibit discrimination among similarly situated franchisees. Hawaii, Indiana, Iowa, and Washington also regulate a franchisor's right to limit their franchisees to purchasing goods or services from the franchisor or approved sources. Finally, a number of states do not allow a franchisor to require that litigation be conducted in an out-of-state forum.

Exemptions and Exclusions. There are various exemptions adopted under federal and state laws, but they are far from uniform. Some provide for exemption from registration and disclosure; others from registration only. Among the more typical exemptions are those for high net worth franchisors, often paired with an experience component; sophisticated franchisee exemptions, based on the franchisee's net worth, experience, or investment; and fractional franchises, which involve situations in which the franchised business comprises a small part of the franchisee's overall business.

Business Opportunity Laws. Even more states have enacted laws regulating business opportunities, sometimes referred to as seller-assisted marketing plans. The FTC now has a separate Business Opportunity Rule. Many of these laws contain exemptions for franchises, conditioned on annual or one-time filings and compliance with the FTC Rule's requirements. Like franchise laws, business opportunity laws are broad in the transactions they cover and their registration and disclosure requirements are generally less uniform across states than those in the franchise arena. The transactions covered involve payment of a fee for products or services to conduct a business in which the seller makes at least one of several types of representations. Representations that a purchase price is refundable, or on issues like earning power, site assistance, or marketing plans, can all trigger coverage of business opportunity statutes.

Disclosure Issues

FDD Disclosure Format. Franchisors must present information on 23 different disclosure topics in their FDDs: the franchisor and its parents, predecessors, and affiliates; the business experience of its principal officers, directors, and managers; litigation; bankruptcy; initial fees that the franchisee must pay; other fees; an estimate of the franchisee's initial investment; restrictions that the franchisor imposes on products and services; the franchisee's obligations during the relationship; financing that might be available through the franchisor; the franchisor's obligations to provide assistance and information about advertising, computer systems, and training; the territorial rights that the franchisee will receive; the franchisor's trademarks; its patents, copyrights, and proprietary information; the franchisee's obligation to participate in the actual operation of the franchise business; restrictions on what the franchisee may sell; information about renewal, termination, transfer, and dispute resolution; any public figures who endorse the franchise; optional financial performance representations; information about outlets and franchisees; the franchisor's financial statements; a list of contracts required of the franchisee; and a receipt form.

There are a number of sources to consult in preparing a franchise disclosure document. In addition to the FTC Rule itself, there is the FTC's Statement of Basis and Purpose, an information-rich analysis down to its instructive footnotes. The FTC also issued a Compliance Guide in May 2008 that contains sample answers. The FTC staff respond to questions that arise periodically through interpretive opinions and FAQs on its website (*www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml*).

The Role of NASAA. Founded in 1919, the North American Securities Administrators Association is the oldest international investor protection organization and consists of 67 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Islands, Puerto Rico, Canada, and Mexico. The role of its Franchise and Business Opportunities Project Group is important in promoting uniformity and working with the FTC on interpretations of disclosure requirements. NASAA amended the UFOC Guidelines in July 2008 to adopt the FTC's disclosure format and to overhaul the registration process and forms. In 2009, NASAA issued its latest Commentary on disclosure requirements in an easily accessible question-and-answer format. Most recently, in September 2009, the Statement of Policy on Uniform Franchise Delivery Requirements was issued by NASAA to encourage states to adopt the same timing and cooling-off periods as the FTC Rule requires.

Specific Registration and Disclosure Issues. Financial performance representations (FPR), formerly referred to as "earnings claims," are an optional disclosure and refer to information given to a prospective franchisee from which a level or range of sales, income, or profit may be ascertained. Except for limited circumstances, a franchisor is restricted from providing this information unless it makes an FPR disclosure in its FDD. Only 30 percent to 40 percent of franchisors actually do make this disclosure. A franchisor that does not make an FPR in its disclosure document is limited to referring prospects to its existing franchisees or to the prospective franchisee's own advisors to ferret out this information.

Consequences of Violations of the Law. The FTC is authorized to bring suit for injunctions and restraining orders

Franchise Law Resources

The **ABA Forum on Franchising** was formed in 1979 and presents an annual symposium on franchise law every October. Membership includes a subscription to the *Franchise Law Journal*, the preeminent legal journal on franchising, and *The Franchise Lawyer*, which keeps members up-to-date on developments in franchise law and Forum events. The Forum Committee also publishes books and monographs on franchise topics. Membership also includes a directory listing members alphabetically and geographically. Another popular service offered by the ABA Forum on Franchising is its listserv, available worldwide to members and nonmembers alike. Its archives are searchable on the ABA's website. See *www.abanet.org/forums/franchising*.

The **International Franchise Association** was founded in 1960 and is comprised of franchisors, franchisees, and suppliers. It hosts an annual legal symposium in Washington, D.C., every May. See *www.franchise.org*.

The year after the first meeting of the Forum Committee on Franchising, and largely as a result of concerns raised by that group, Commerce Clearing House began publishing the **Business Franchise Guide** in 1980. The *Business Franchise Guide* is the best single source for franchise and distribution decisions, including state, federal, and arbitration, whether published or not. The *Business Franchise Guide* also includes a guide to state and federal laws and regulations related to franchising and distribution.

against violators of the FTC Rule. By administrative action, the FTC can issue an order requiring a franchisor to cease and desist from further violations of the Rule. While there is no private right of action under the Rule, the FTC may bring actions on behalf of franchisees, and can seek civil and criminal penalties. As with state statutes, liability may extend to officers, directors, and control persons of the franchisor individually.

State franchise statutes also provide for both civil and criminal remedies against both the franchisor and the persons responsible for violating the law. With respect to civil actions, state laws recognize private remedies, including equitable relief and rescission.

Violation of state registration laws and relationship statutes may give rise to administrative enforcement proceedings. Regulators have the power to obtain orders suspending franchise sales during the course of a proceeding and may seek damages, rescission, attorneys' fees, fines and penalties, costs, and other remedial measures.

Franchise relationship statutes may provide franchisees with various remedies including an obligation to repurchase unsold inventory, equipment, and other assets, in addition to damages, injunctive relief, and attorneys' fees. There is some case law limiting a franchisor's right to obtain damages where the franchisor has terminated the franchise agreement.

Issues in the Franchise Relationship

Following is a summary of some of the hot-button issues that have occupied franchisors, franchisees, and the courts over the past decade.

Encroachment. Franchisors almost always retain the right to deliver the goods and services associated with the brand through other outlets, whether owned by the franchisor or another franchisee. Franchisors also may distribute goods through alternate channels of distribution such as the Internet, mail order, catalog sales, or sales of branded products through supermarkets. Franchisees have challenged such rights as encroachment upon their franchise rights.

The high-water mark for encroachment claims probably came with the decisions in *Scheck v. Burger King*, 756 F. Supp. 543 (S.D. Fla. 1991) and *Vylene Enterprises, Inc. v. Naugles, Inc*., 90 F.3d 1472 (9th Cir. 1996) (citing *Scheck* with approval). *Scheck* held that even where a franchisor provided a nonexclusive territory to a franchisee, the franchisor did not necessarily retain an unfettered right to place other units in the surrounding area unless that right was expressly retained. The reasoning in *Scheck* was later disavowed in *Burger King Corp. v. Weaver*, Bus. Franchise Guide (CCH) ¶ 10,762 (S.D. Fla. 1995), but the case continues to be cited and encroachment disputes are common.

Inconsistent results have been obtained in cases challenging the franchisor's use of alternate channels of distribution, usually turning on the specific language in the franchise agreement. Internet sales by franchisors also have proven nettlesome. *Emporium Drug Mart, Inc. v. Drug Emporium, Inc.*, Bus. Franchise Guide (CCH) ¶ 11,966 (AAA 2000), although only an arbitration award, is often cited to support franchisee claims. In other circumstances, Internet sales have been upheld.

Systemwide Change. Franchise relationships are usually long-term relationships that, with renewals, can span generations. As times change, franchisors change their systems to remain competitive: systemwide changes are usually established by changes in the operations manual. Franchisees are not always happy with systemwide changes dictated by the franchisor and this issue is often litigated. Generally, the right of franchisors to make changes in their systems has been upheld. The franchisor's right to change the system may be limited where it directly benefits the franchisor at the franchisees' expense.

Antitrust Issues. At one time, the battle between franchisors and franchisees was waged primarily in the antitrust arena. Following the decision in *Siegel v. Chicken Delight*, 448 F.2d 998 (9th Cir. 1971), which found a required purchase of restaurant equipment to be an unlawful tie, such issues were commonly litigated in franchising. This argument was firmly rejected in *Queen City Pizza, Inc. v. Domino's, Inc.*, 124 F.3d 430 (3d Cir. 1997), where the court held that Domino's could eliminate other authorized suppliers and designate itself as the sole authorized supplier of pizza ingredients without creating an unlawful tie.

Not a Fiduciary Relationship. Courts for the last 25 years have held that the franchise relationship is not a fiduciary relationship.

Vicarious Liability. Franchisors are often sued by persons who allege that they were injured on franchised premises. Generally, franchisors are not liable for such claims if they do not control the day-to-day operations of the franchised location.

Noncompetition. A frequent source of contention in the franchise relationship arises from covenants against competition. State law varies widely on this issue. Generally, in-term covenants are considered to be enforceable, with post-term covenants enforceable in some states and against strong public policy in others. *See*, *e.g.*, *Scott v. Snelling & Snelling, Inc.*, 732 F. Supp. 1034, 1042 (N.D. Cal. 1990).

In some states, covenants will be enforced if they impose reasonable geographical or temporal limits on competition. Some states will blue-pencil defective noncompetition provisions to bring them into compliance with the law, while others decline to do so. The best resource on the state laws is *Covenants Against Competition in Franchise Agreements,* Second Edition, published by the American Bar Association.

Trade Secrets and Trade Dress. Franchisors may freely enforce their rights to protect trade secrets and trade dress. Many states have adopted the Uniform Trade Secrets Act. The Act generally protects information, methods, and processes that have independent economic value because they are not generally known to the public, and where there have been reasonable efforts to maintain secrecy.

Transfer of System by the Franchisor. Franchisors generally retain an unlimited right to sell franchise systems. Franchisees have frequently challenged these sales, with little success. In *Century Pacific v. Hilton*, 528 F. Supp. 2d 206 (S.D.N.Y. 2007), the court held that a franchisor had the right to exercise its contractually retained right to sell the Red Lion franchise system, despite franchisee claims that they had been promised it would never be exercised.

Violation of Brand Standards. Where franchisees fail to adhere to minimum brand standards, franchisors may bring suit to terminate the franchise. The right to do so may be limited by both contractual and statutory limitations, including notice and an opportunity to cure. Suit also may be brought against a terminated franchisee for continued use of trademarks. Such suits are usually brought under the Lanham Act.

International Franchising

The FTC has indicated that it will enforce the requirements of the Franchise Rule in the United States and its territories. Some states, such as New York, however, have laws with broad jurisdictional provisions that could extend to international transactions. Franchisors expanding into other countries also have to contend with an increasing number of non-U.S. jurisdictions that regulate franchising, as well as with laws on such wide-ranging matters as commercial agency, technology transfer and language, choice of law, and venue restrictions.

Conclusion

In the 40 years since the first franchise law was enacted, the law of franchising has burgeoned into a complex international web of statutes, regulations, and cases. As will become apparent after reading the other articles in this issue, the field of franchise law draws upon a wide range of disciplines and contains many traps for the unwary.