WHAT IS A "FRANCHISE" AND WHY DOES IT MATTER?

Presented by

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VIRGINIA BAR ASSOCIATION
Summer Meeting
The Homestead
July 19, 2013

I. Introduction

Franchises are everywhere. McDonald's, Subway, and KFC have been household names for decades and newer businesses have expanded the use of the franchise model into dozens of industries that are less well-recognized as being suitable for franchising, like home health care, website development and marketing, business coaching and home renovations, to name a few. The positive side of ubiquity is that most people are fairly comfortable that they understand the concept of franchising. Unfortunately, too many people are wrong.

Franchising is a highly regulated business model, but licenses[1] are not. So, any misunderstanding over what is and is not a franchise could have severe implications for unwitting franchisors and their lawyers. As described below, being classified as a franchise leads to significant legal compliance obligations and the increased costs that accompany them. Those increased costs could weigh heavily in favor of a different form of distribution if the issue is raised early enough in the business planning stage. Of course, sometimes businesses who believe they have been offering licenses find out that their licenses have been franchises only after committing themselves to the business model and exposing themselves to civil, regulatory and even criminal liability. A lawyer who has failed to properly counsel a client and led them into pursuing an "accidental franchise" model may find themselves facing legal malpractice claims.[2] So, in short, choosing the right model – and knowing how to avoid ambiguity about which model is being used – matters quite a lot.

II. Why It Matters

A. Disclosure/Registration Laws[3]

The sale of franchises in the United States is regulated at the federal level by a Federal Trade Commission rule typically referred to as the "FTC Rule" or the "Franchise Rule."[4] Generally, the FTC Rule requires that anyone offering or selling a franchise in the United States prepare a detailed document containing 23 items of prescribed disclosures and provide that document to any prospects and allow those prospects to have at least 14 days to review the document before signing and agreements committing them to purchasing the franchise or paying any money to the franchisor. This disclosure document is typically referred to as a "Franchise Disclosure Document" or "FDD".[5]

Although the FTC Rule applies throughout the United States, it is not the last word on franchising in many states. The FTC Rule expressly does not preempt state laws that provide franchisees with greater protections than those provided by the FTC Rule. Consequently, a number of states have enacted laws that govern franchises. These laws, generally, take the form of either presale registration and disclosure laws, relationship laws, or a combination of both.

1. FDD

The contents of the FDD are prescribed by the FTC Rule. But, it is important to note that the FTC Rule itself is probably an inadequate resource from which to prepare an FDD. Because of practical nuances, debatable definitional issues and other areas of ambiguity, the FTC has published a "Compliance Guide" and an "FAQ" which are intended to further explain the rationale behind various portions of the FDD requirements or the application of the FTC Rule. Of course, these pronouncements are in addition to the Statement of Basis and Purpose that accompanied the issuance of the Rule. Also, the FTC has acknowledged the long history of state franchise law in shaping the disclosure requirements and NASAA's role in clarifying them by stating that it was the FTC's intent to codify existing practice (under the old FTC Rule and the NASAA-promulgated UFOC Guidelines) unless the FTC Rule is explicitly in conflict.[6] The result of this is that a well-intentioned lawyer who attempts to prepare an FDD for a client could easily overlook some of the more esoteric interpretations of the FTC Rule.

a. Prescribed format – 23 "Items"

The FDD format is laid out in detail in the FTC Rule. For the most part, the disclosures that are required fall into 3 categories: (1) issues that are addressed specifically in the agreement between the franchisor and franchisee, (2) information about the franchisor, its business and the system as a whole, and (3) issues about the relationship that may not be addressed in the franchise agreement.

To a business-owner trying to determine whether to be a franchise, the cost of preparing this document may be enough to argue against adopting a franchise model. But, cost may not be the only consideration.

b. Potentially embarrassing or inconvenient disclosures

Several FDD disclosure items require that a franchisor disclose information that might be embarrassing or inconvenient. For example, Item 3 requires that a franchisor disclose certain pending or concluded litigation involving the franchisor or, in some cases, a parent or an affiliate. Item 4 requires disclosure of any bankruptcy history of the franchisor, any predecessor, affiliates or officers of the franchisors. Item 8 requires disclosure of whether the franchisor receives payments from third parties (i.e., rebates) and whether any of the franchisor's officers own any interest in any third party supplier. Item 20 requires disclosure of contact information of existing franchisees and any franchisees that have left the system with the last year. Any one of these disclosures could force a franchisor to share information that they might view as damaging.

c. Restrictions on Financial Performance Claims

It is not surprising that the most significant element to any prospective franchisee's decision to purchase (or not to purchase) a franchise is the amount of money that they may be able to make by operating the business. Consequently, the FTC Rule requires that if a franchisor will make any financial performance claims during the sales process, it must [7] include those claims in the FDD and they must have a reasonable basis for the claim and written substantiation of it. If a franchisor does not include a financial performance representation in the FDD, it may not make any claims to prospects. If a franchisor does not have any data on which to base a financial performance representation, it may have significant difficulty communicating its value proposition to prospects effectively.

2. Cost

Despite the potential for the FDD to contain embarrassing, inconvenient or even damaging disclosures is rarely sufficient to lead a potential franchisor to abandon the model. It is much more likely that cost will be the driving factor behind the company's decision to adopt a franchise model or something else.

a. Legal

As noted above, the FDD requires disclosure – and consequently identification, analysis and presentation – of a significant volume of data. That requires a significant investment of time – and money – at the outset. Of course, the exact amount of time and money will vary widely based on the nature of the business, the complexity of the particular franchise model and the experience of counsel. But, it is fair to say that preparation of a typical FDD (and its related documentation) can easily demand more than 100 hours of billable time.

b. Accounting (audit)

One of the 23 required disclosure items in the FDD is the franchisor's financial statements. Generally, these financial statements must be audited and prepared in accordance with GAAP. The FTC Rule allows for some new franchisors to phase-in the audit requirement, which might reduce the cost burden initially. But, not all states will allow for the audit phase-in[8] and all states will require that audited statements be prepared on a going-forward basis.

c. State filings (see below) – legal and filing fees

As noted above, several states require that the FDD (and other materials) be filed with a state agency before a franchisor may even solicit the sale of a franchise in their state. The state filing processes vary by state, but each filing typically requires payment of a fee and many involve a detailed review of the FDD and related documentation and, often, revisions to the documents to address any comments or concerns raised by the state examiner. Extensive comments and revisions requested by state examiners can lead to unforeseen legal costs.

d. At least annual updating

Much of the information in the FDD is intended to reflect the status of the franchisor or the franchise system at a particular moment in time (generally, as of the close of the franchisor's most recent fiscal year). Consequently, that information can quickly become out-of-date. For the disclosures in the FDD to be meaningful – and to comply with the FTC Rule – a franchisor must update the document at least once a year. If there are "material" changes during the franchisor's fiscal year, those changes must be incorporated at least quarterly. Those changes, once made, will also typically require amending any existing state franchise registrations. The cost to update the FDD annually or quarterly is a fraction of the cost to prepare an FDD from scratch, but the ongoing obligation can burden the franchisor.

e. Bookkeeping/Administrative/Training

Compliance with the franchise laws requires that someone within the company know and understand what the legal obligations of a franchisor are. In addition to the disclosure obligations mentioned above, a franchisor has administrative and bookkeeping obligations in the sales process and in maintaining state registrations. To avoid liability in these areas, a franchisor should ensure that someone in the company is trained on these matters and has sufficient responsibility to ensure compliance for the business.

3. Delays

One of the great detriments to the franchise business model is that it greatly limits a franchisor's ability to react quickly when opportunities arise. If one assumes that a license agreement and a franchise agreement involve the same amount [9] of time, effort and money to prepare, from an operational point of view the only difference (other than cost) for the client is that a license arrangement can be entered into as soon as the parties can arrive at an agreement, but the franchise relationship may be burdened by delays mandated by statute, rule or process.

a. Time to prepare FDD

As noted above, preparing the FDD is a time-consuming process that can easily take at least 100 hours of lawyer labor. But, it also involves time for a client to read, review, understand and provide input on the documents. Consequently, the process to prepare an FDD (and the related agreements) can take months. If the franchisor is responding to market pressures to expand their business, this delay can be fatal.

b. 14-day disclosure

Once the FDD is prepared and a prospective franchisee is identified, the FTC Rule requires that the prospect be given the opportunity to review the FDD (and its attachments) for at least 14 days before any agreement can be signed or money paid to the franchisor.[10]

c. 7-day disclosure

The FTC Rule also requires that a prospect be given the final "execution copy" of the agreements at least 7 days before signing or paying any money.[11] This period can run concurrently with the disclosure period mentioned above, but if there are negotiations that require producing amendments to the agreements, this 7-day disclosure period may further delay the franchisor's business plans.

d. State filing process/pipeline re-disclosure

As noted above, the state filing process may involve review and comment by a state administrator. The response times from the states vary widely by state and by time of year. It is common for certain states not to respond to an initial franchise registration filing for more than a month. And, if there are comments that must be addressed, the franchisor's ability to solicit, offer or sell franchises in that state may be delayed for several months after the FDD was finally complete.

B. Relationship Laws[12]

Many states have enacted additional laws meant to protect franchisees during the term of the franchise relationship. Typically, these laws limit a franchisor's ability to terminate the franchise relationship except for "cause" or "just cause" or "reasonable cause." Most of these laws also limit a franchisor's ability to refuse to renew or consent to transfer a franchise. While these laws may impose additional costs and have a significant impact on the ability of a franchisor to manage its system, because their effects are hypothetical and remote these laws do not normally drive the choice of business model decision.

III. What is a Franchise?

After hearing of the onerous requirements placed on a franchisor by a vast patchwork of laws, it is no wonder that many businesspeople and their counsel go to great lengths to avoid them. Of course, to avoid being regulated as a "franchise" we have to first understand what a "franchise" is according to the laws and regulations that impose the burdens. Complicating this task is the fact that there are at least three different (though similar) definitions of a "franchise" that must be evaluated. Each definition contains three elements that must be met for a franchise to be found, and only one the three elements varies significantly from one definition to the other. The FTC Rule's definition refers to the "control or assistance" offered by the franchisor. Most states instead refer to the offering of a "marketing plan or system" by the franchisor. And, other states refer to a "community of interest" that exists between the franchisor and the franchisee.

A. FTC Rule

The FTC Rule states that:

> *Franchise* means 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.[13]

Like the alternative definitions in various state laws (discussed below), this definition identifies three elements, all of which must be necessary for a franchise to exist. In general, the three elements are generally referred to as: (a) the trademark element, (b) the "control or assistance" element, and (c) the fee element. Each of these elements has their own nuances.

1. Trademark Element

The FTC Rule's treatment of the trademark element is fairly straightforward. But, there are a few fine points worth noting. First, the right to use the trademark must be "to operate a business that is identified or associated with" the trademark. While the FTC has not opined on whether the right to "operate a business" that is "identified or associated with" a trademark is intended to cover only relationships where the business is doing business under the trademark, one could easily make that argument. But, the FTC did not require that the business be "solely" identified or associated with the franchisor's trademark, so it is conceivable that a franchisee could be operating under more than one trademark and a franchise could exist where only one of those marks is the franchisors. It is also important to remember that the FTC Rule is, effectively, a consumer protection law and will be interpreted broadly to give effect to the intent statute: to protect consumers.

2. Control or Assistance Element

The "control or assistance" element is the element that captures the essence of what makes a franchise different than a typical license. This element suggests that the franchisor has some special ability or knowledge that the franchisee will be dependent on in the operation of the business. Whether that ability or knowledge may be conveyed through prescribed or suggested methods is not critical. Either way, a person purchasing the franchise will be looking for help from the franchisor.

The FTC has identified several types of control or assistance that can be "significant", including: site approval, design and appearance requirements, hours of operation, production techniques, accounting practices, personnel policies, promotional campaigns, restrictions on customers, territory limitations or protections, training programs, providing an operating manual, a system-wide network or website, and advice on management, marketing or personnel, among others.[14] This list is incredibly broad, but the FTC has stated that to be "significant" the elements of control or assistance present must also "relate to the franchisee's overall method of operation."[15]

3. Required Payment Element

Too many non-franchise lawyers assume that if there is no fee paid to enter into the relationship, the required payment element will not exist. Similarly, many people assume that a franchise must involve a periodic royalty. As a result, they often try to avoid being deemed to be a franchise by characterizing payments made to the franchisor as something less obvious. This is a mistake. The language of the FTC Rule does not limit the types of payments that may trigger application of the FTC Rule. In fact, the Compliance Guides specifically include the following payments as possible required payments: initial franchise fees, rent, advertising assistance, purchase of equipment and supplies, training fees, various deposits, bookkeeping charges, purchase of promotional literature, equipment rental, and royalties. It is important to note that the FTC even views payments made to third parties as possible required payments for the purposes of the FTC Rule if the third party compensates the franchisor as a result of the franchisee's payment. Also, the FTC does not limit the required payment element to only payments that are expressly required; payments required by "practical necessity" are also deemed to be required payments. The only category of payments that the FTC has excluded from the term "required payment" is a payment made for a "reasonable amount of inventory at bona fide wholesale prices for resale or lease."[16]

B. State Definition -- Marketing Plan or System

At the state level, most state franchise laws[17] follow the "marketing plan or system" definition of a franchise. Virginia's Retail Franchising Act is typical:

> "Franchise" means a written contract or agreement between two or more persons, by which:
>
> 1. A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services at retail under a marketing plan or system prescribed in substantial part by a franchisor;
>
> 2. The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and
>
> 3. The franchisee is required to pay, directly or indirectly, a franchise fee of $500 or more.[18]

The phrase that distinguishes this definition from the FTC Rule is "a marketing plan or system prescribed in substantial part by a franchisor." But, determining what this phrase means is no easy task. Most state statutes do not expand on the definition of the phrase. "Instead, most interpretations are found in regulations, interpretive releases, advisory opinions, and judicial decisions."[19] If you were to read the definition above literally, you might infer that making any marketing plan or system option on the part of the franchisee would be enough to avoid that application of the marketing plan or system element of this definition. But, several states take the view that a marketing plan or system can be "prescribed" even if it is only "suggested".[20]

C. Community of Interest

A minority of state franchise laws follow the "community of interest" definition of a franchise. For example, under the Minnesota franchise law, a franchise is:

> […] a contract or agreement, either express or implied, whether oral or written, for a definite or indefinite period, between two or more persons:
>
> (i) by which a franchisee is granted the right to engage in the business of offering or distributing goods or services using the franchisor's trade name, trademark, service mark, logotype, advertising, or other commercial symbol or related characteristics;
>
> (ii) in which the franchisor and franchisee have a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise; and
>
> (iii) for which the franchisee pays, directly or indirectly, a franchise fee […][21]

The "community of interest" phrase is extremely vague and capable of extremely broad interpretation. The closest thing to a specific definition of what a "community of interest" means was provided by the Wisconsin Supreme Court in *Ziegler Co. v. Rexnord, Inc.*, in which it identified ten factors to consider in determining whether a "community of interest" exists. According to the Court, these factors include:

> [H]ow long the parties have dealt with each other; the extent and nature of the obligations imposed on the parties in the contract or agreement between them; what percentage of time or revenue the alleged [franchisee] devotes to the alleged [franchisor's] products or services; what percentage of the gross proceeds or profits the alleged [dealer] derives from the alleged [franchisor's] grant of territory to the alleged [franchisee]; the extent and nature of the alleged [franchisee's] uses of the alleged [franchisor's] proprietary marks (such as trademarks or logos); the extent and nature of the alleged [franchisee's] financial investment in inventory, facilities, and goodwill of the alleged [franchise]; the personnel which the alleged [franchisee] devotes to the alleged [franchise]; how much the alleged [franchisee] spends on advertising or promotional expenditures for the alleged [franchisor's] products or services; the extent and nature of any supplemental services provided the alleged [franchisee] to consumers of the alleged [franchisor's] products or services.[22]

In evaluating each of these factors, a "community of interest" will exist if shared both (a) a continuing financial interest, and (b) interdependence.[23]

D. A Note on Franchise Laws as Consumer Protection Laws

All federal and state franchise laws and regulations are based on a legislative intent to remedy abuses of investors by franchisors. Under this point of view, franchisees are (often, at least) less sophisticated individuals (or entities) than their franchisor counterparts, are less likely to be advised by competent counsel, and posses less information than the franchisor about the business relationship. Also, a franchisee often invests a disproportionate share of their assets in a business that could be extinguished entirely by a franchisor's whim, if not protected by the law. So, all franchise laws are, effectively, consumer protection laws. If creative drafting could create a relationship functionally the same as a franchise, without being deemed a franchise, the law would be completely ineffective to achieve its goal. The effect of this is that when applying the franchise laws, the definitions will be interpreted broadly to give effect to the legislature's intent.

IV. Exemptions

The FTC and most states have identified certain relationships which, for one reason or another, they have determined should not be subject to the franchise laws, despite the fact that the statutory definition would apply. The available exemptions vary significantly between the federal and state laws and from state to state. In some cases, a franchisor seeking to avoid the franchise laws can make use of one or more exemptions to allow it to operate as if it were a franchise without the compliance obligations associated with being one. A summary of the available exemptions is beyond the scope of this paper, but anyone advising a potential franchisor should evaluate the availability of exemptions and analyze the risks associated with doing so before proceeding with a traditional franchise program.[24]

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[1] It is important to note that franchises are a type of license. In this paper, we use the terms "franchise" and license" often as if they were mutually exclusive, because that is the way the terms are typically used by business people and many lawyers. A better way to describe the two categories might be "franchise licenses" and "mere licenses".

[2] *See, e.g., Sickler v. Kirby*, 805 N.W.2d 675 (Neb. 2011).

[3] Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. §436 (2007); California Franchise Investment Law, CAL. CORP. CODE §31000 et seq.; Hawaii Franchise Investment Law, HAW. REV. STAT. §482-E1 et seq.; Illinois Franchise Disclosure Act, ILL. COMP. STAT. §705/1 et seq.; IND. CODE §23-2-2.5-1 et seq.; Maryland Franchise Registration and Disclosure Law, MD. CODE ANN., BUS. REG. §14-201 et seq.; Michigan Franchise Investment Law, MICH. COMP. LAWS §445.1501 et seq.; MINN. STAT. §80C.01 et seq.; N.Y. GEN. BUS. LAW §680 et seq.; Oregon Franchise Transactions Law, OR. REV. STAT. §650.005 et seq.; Rhode Island Franchise and Distributorship Regulations Act, R.I. GEN. LAWS §19-28.1-1 et seq.; South Dakota Franchises for Brand-Name Goods and Services Law, S.D. CODIFIED LAW §37-5B-1 et seq.; Virginia Retail Franchising Act, VA. CODE ANN. §13.1-557 et seq., Washington Franchise Protection Act, WASH. REV. CODE §19.100.010 et seq.; Wisconsin Franchise Investment Law, WIS. STAT. §553.01 et seq.

[4] 16 C.F.R. §436. The FTC Rule was recently amended, effective July 1, 2007. The latest iteration of the FTC Rule is sometimes referred to as the

"Amended Rule".

[5] Under the previous version of the FTC Rule, the form of document most frequently used to comply with the FTC Rule was called a "Uniform Franchise Offering Circular" or "UFOC". The UFOC format was developed by The North American Securities Administrators Association and was accepted by the FTC as compliant with the FTC Rule's requirements.

[6] Statement of Basis and Purpose-2007, 72 Fed. Reg. 61 at I.E.

[7] 16 C.F.R. §436.4(s)(3).

[8] Based on the author's experience with state franchise regulators and the office policies of each of their offices, Minnesota, New York and Virginia do not accept a phase-in of the audit requirement. California and Illinois may allow a phase-in if the financial statements included are "reviewed" or "compiled" at a minimum.

[9] This is a dubious proposition. Franchise agreements typically are much longer, as they often must address possible unforeseen circumstances that could result from case law specific to franchising.

[10] 16 C.F.R. §436.2(a).

[11] 16 C.F.R. §436.2(b).

[12] ALASKA STAT. §45.45.700 *et seq.*; Arkansas Franchise Practices Act, ARK. CODE ANN. §4-72-201 *et seq.*; California Franchise Relations Act, CAL. BUS. & PROF. CODE §20000 *et seq.*; CONN. GEN. STAT. §42-133e *et seq.*; Delaware Franchise Security Law, DEL. CODE ANN. Tit. 6 §2551 e*t seq.*; Hawaii Franchise Rights and Prohibitions Act, HAW. REV. STAT. §482-E6; Illinois Franchise Disclosure Act, ILL. COMP. STAT. §§705/18-705/20; Indiana Deceptive Franchise Practices Law, IND. CODE §23-2-2.7-1 *et seq.*; IOWA CODE §§523H.1 *et seq.* and 537A.10; Michigan Franchise Investment Law, MICH. COMP. LAWS §445.1527; MINN. STAT. §80C.14; MISS. CODE ANN. §75-24-51 *et seq.*; MO. REV. STAT. §§407.400 *et seq.* and 407.420; Nebraska Franchise Practices Act, NEB. REV. STAT. §87-401; New Jersey Franchise Practices Act, N.J. REV. STAT. §56-10-1 *et seq*.;Rhode Island Fair Dealership Act, R.I. GEN. LAWS §6-50-1 *et seq*.; Utah Consumer Sales Practices Act, UTAH ADMIN. CODE r. R152-11-11; Virginia Retail Franchising Act, VA. CODE ANN. §13.1-564; Washington Franchise Investment Protection Act, WASH. REV. CODE §§19.100.180 and 19.100.190; Wisconsin Fair Dealership Law, WISC. STAT. §135.01 *et seq*.; District of Columbia Franchising Act, D.C. CODE §29-1201 *et seq*.; Puerto Rico Dealers' Contracts Act, P.R. LAWS ANN. tit. 12A §278 *et seq*.; Virgin Islands Franchise Business Act, V.I. CODE ANN. tit. 12A §130 *et seq*.

[13] 16 C.F.R. §436.1(h).

[14] FTC RULE COMPLIANCE GUIDE (May 2008).

[15] *Id.*

[16] *Id.*

[17] California, Illinois, Indiana, Maryland, Michigan, New York, North Dakota, Oregon, South Dakota, Rhode Island, Virginia, Washington and Wisconsin use the "marketing plan or system" formulation. See note 3, *supra*.

[18] VA. CODE ANN. §13.1-559.A. But, it should be noted that Virginia's reference to "at retail" is unique.

[19] John R.F. Baer, David A. Beyer and Scott P. Weber, *When are Sales Representatives Also Franchisees?*, 27 FRANCHISE L.J. 151, 153 (2008).

[20] California, Illinois, Maryland and Wisconsin. See note 3, *supra.*

[21] MINN. STAT. §80C.01.4(a)(1).

[22] 407 N.W.2d 873, 879-80 (Wis. 1987). Note that the Wisconsin statute referred to in *Ziegler* – the Wisconsin Fair Dealership Law -- actually refers to "dealers" and "dealerships" instead of franchisees. However, the formulation of the definition of "dealer" under that statute is nearly identical to the definition of "franchise" under the other state laws using the "community of interest" definition.

[23] *Brio Corp. v. Meccano S.N.*, 690 F. Supp. 2d 731, 740 (E.D. Wis. 2010).

[24] *See* Patrick J. Maslyn, Timothy O'Brien, Anne Connelly and Dennis Wieczorek, *Go to the Head of the Line: How to Get Registered, Amended, Renewed or Exempted*, American Bar Association 34th Annual Forum on Franchising (2011).