NEW YORK STATE BAR ASSOCIATION

BUSINESS LAW SECTION FALL MEETING

INTRODUCTION TO FRANCHISE LAW

September 17, 2011
Cooperstown, NY

THE INADVERTENT FRANCHISOR

When do the franchise laws apply?
Varieties of franchise and business opportunities laws

---

by

Thomas M. Pitegoff
Pitegoff Law Office PLLC
White Plains, NY
914-681-0100
www.pitlaw.com
pitegoff@pitlaw.com

THE INADVERTENT FRANCHISOR

Contents

THE INADVERTENT FRANCHISOR

I. WHY SHOULD YOU CARE ABOUT FRANCHISE LAW?

Franchising is Highly Regulated – The early success of franchising in the 1950s and 1960s attracted many questionable characters who sought their fortunes through fraud and unfair practices. As a result, a number of states enacted laws in the 1970s to regulate the industry, and the Federal Trade Commission initiated regulation at the federal level. The franchise laws have effectively cleaned up the industry. Today, franchising is highly regulated, and the industry enjoys a positive image. Yet, despite its size and the fact that it is highly regulated, relatively few lawyers are familiar with the franchise laws.

Franchise sales laws in New York and several other states require franchise registration. Both federal and state franchise sales laws require franchisors to deliver a franchise disclosure document to each prospective franchisee. Some states that don't have franchise sales laws have business opportunity laws that may nevertheless require a presale filing in certain cases. Franchise "relationship" laws in a number of states limit the franchisor's ability to terminate a franchise or to refuse to renew a franchise without good cause.

Each state takes a different approach to franchise regulation. For example, Connecticut has both a franchise relationship law and a business opportunity law, but no franchise sales law. New Jersey has a franchise relationship law but no franchise sales law and no business opportunity law. New York has a franchise sales law but no franchise relationship law and no business opportunity law.

Avoid Malpractice by Recognizing the Scope of the Franchise Laws – Franchise laws cover more than the business format franchise that we commonly recognize as a franchise. License agreements, service agreements and distribution agreements of many varieties can fall within the scope of the franchise laws. In one reported decision, a Connecticut law firm was held liable for almost $16,000,000 in damages for a client company's lost profits when an associate at the firm failed to recognize the need to file a franchise offering as a "business opportunity" under the Connecticut Business Opportunity Investment Act.[1] The franchise offering fell under the state's business opportunity law. The lawyer handling the matter thought that the offering was exempt because it included the license of a trademark for which a federal trademark application was pending. In fact, the offering was not exempt because the U.S. Patent and Trademark Office had not yet issued the federal trademark registration. Although the Connecticut Supreme Court reversed the trial court's award of damages, the defendants did not challenge the holding of legal malpractice.

[1] Beverly Hills Concepts, Inc. v. Schatz and Schatz, Ribicoff and Kotkin (CT Superior Court, 1997), Bus. Franchise Guide (CCH) ¶11,099; *aff'd* (CT Supreme Court, 1998), Bus. Franchise Guide (CCH) ¶11,488.

This paper seeks to clarify the scope of the franchise laws to help the novice franchise lawyer or the non-franchise lawyer recognize franchise law issues and assist clients in determining whether a proposed business arrangement is a franchise. The answer is not always clear or simple.

Assist the Client Who Wants to Avoid Franchising – Some clients want to avoid franchising because they view compliance as complicated and costly. Other clients may already face allegations that their business falls within the scope of the franchise laws. In order to avoid the franchise laws or respond to an allegation that your client's business is a franchise, you need to know the contours of the franchise laws. Under many license and distribution scenarios it is not possible to avoid these laws. In other cases, you can avoid franchising with careful planning. If you happen to cross the line without realizing it, it may be far more costly to manage the violation of the franchise laws than it would have been to comply with the legal requirements of those laws in the first place. Before you take steps to avoid the franchising, you should bear in mind the fact that many companies have been very successful expanding their businesses through franchising, notwithstanding the existence of extensive regulation.

Advise Your Client Before Terminating or Refusing to Renew a Distributorship – Your client may seek your advice before terminating the agreement of a licensee, distributor or sales representative. The franchise relationship laws cover many of these types of agreements, limiting contract rights in many cases. You will need to take these laws into account when advising clients on questions of termination and nonrenewal transfer.

Help Your Client Expand By Franchising – Finally, the more familiar you are with franchise law and practice, the better you will be able to assist your client in establishing a franchise offering that complies with the state and federal requirements, and in complying with those laws on an ongoing basis.

II. OVERVIEW OF THE FRANCHISE LAWS

A. Franchise Sales Laws and Franchise Relationship Laws

The franchise laws fall into two basic categories: those that regulate franchise sales and those that regulate the substantive relationship between the franchisor and franchisee. Franchise sales laws require franchisors to make certain disclosures to prospective franchisees before a franchise is sold. Franchisors make these disclosures by delivering to prospective franchisees a disclosure document that is similar to the disclosure document used in the sale of securities. In fact, the franchise disclosure laws are based on the state securities laws. In all states that require franchise registration except Illinois, the same agencies that regulate securities compliance also regulate franchise compliance.

The Federal Trade Commission (the "FTC") requires presale franchise disclosures throughout the U.S. under the FTC's trade regulation rule on franchising.

Most states that require presale franchise disclosure also require franchisors to register their offerings with the state and to keep those registrations current. State examiners can require extensive changes in proposed disclosure documents to bring them into compliance with state regulations.

The second category of franchise laws are generally referred to as the franchise "relationship" laws. Franchise relationship laws regulate the substantive relationship between the franchisor and franchisee after the franchise sale is made. These laws typically limit the franchisor's ability to terminate or refuse to renew without good cause. Part III of this paper focuses on the definition of a "franchise" under the franchise registration and disclosure laws.

B. What Does Complying With the Franchise Sales Laws Entail?

Being a franchise and complying with the franchise registration and disclosure laws requires preparation of a franchise agreement, audited financial statements, a detailed disclosure document, and registration in several states. Franchisors must file disclosure forms with respect to each person involved in selling franchises, and in some states, franchisors must file franchise sales materials. As an ongoing matter, a franchisor must sell franchises in a systematic way that complies with the franchise disclosure requirements. Compliance requires timely delivery of a disclosure document to all prospective franchisees, timely amendments of disclosure documents and renewals of registrations, and annual audited financials.

Companies that are unsure of whether their system falls within the definition of a franchise will find, on the positive side, that complying with the franchise disclosure laws provides a safe harbor. When the client complies with the franchise registration and disclosure requirements, the client need not monitor its business carefully in order to avoid becoming a franchise unwittingly. Compliance allows the client to exercise significant control over the franchise system. After a full analysis of the question, the client may decide that it is more worthwhile to embrace the franchise laws than to avoid them.

C. The FTC Rule

As the states were starting to enact laws regulating franchising in the 1970s, the FTC studied franchising and decided that disclosure was the appropriate approach for federal regulation.

The FTC's trade regulation rule on franchising (the "FTC Rule") became effective in 1979. It requires franchisors to make extensive pre-sale disclosures to prospective franchisees.[2] After a review that lasted more than ten years, the FTC issued a revised FTC Rule in January 2007.[3]

The FTC Rule requires each franchisor to prepare a franchise disclosure document and deliver it to the prospective franchisee before the prospective franchisee signs an agreement or pays any fee to the franchisor. It also prohibits franchisors from making representations to

[2] Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 CFR pt. 436 (1979), Bus. Franchise Guide (CCH) ¶6080.

[3] 72 Fed. Reg. 15,544 (March 30, 2007), www.ftc.gov/bcp/franchise/netfran.shtm.

prospective franchisees beyond the content of the disclosure document. While the FTC Rule applies throughout the U.S., it does not require registration. The FTC Rule contains no substantive provisions regulating the relationship between the franchisor and franchisee other than those relating to the manner and content of the disclosures. It allows for no private right of action. It does not preempt state franchise laws that provide equal or greater protection to franchisees.

Failure to comply with the FTC Rule is deemed to be "an unfair or deceptive act or practice" within the meaning of Section 5 of the Federal Trade Commission Act. Section 5 of that Act provides, in part, as follows: "Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are declared unlawful." Franchise regulation is one small part of the FTC's mandate under the FTC Act.

D. State Franchise Sales Laws

Several states have laws similar to the FTC Rule, requiring franchisors to make extensive disclosures to prospective franchisees before franchises are offered or sold. Unlike the FTC Rule, violation of the state franchise disclosure laws does give rise to a private right of action by the aggrieved franchisee.

California was the first state to enact a law requiring franchisors to register their franchise offering and make disclosures to prospective franchisees to ensure that the franchisees would know what they were buying. The California Franchise Investment Law was enacted in 1970. Today, the following eleven states require registration of the franchise offering, which in some cases entails a lengthy review process and revisions to the franchise disclosure document:

California	North Dakota
Hawaii	Rhode Island
Illinois	South Dakota
Maryland	Virginia
Minnesota	Washington
New York	

In addition, Indiana, Michigan and Wisconsin require simple filings without full review. Oregon requires disclosure but no registration or filing. That makes a total of fifteen states that have franchise disclosure requirements.

E. State Franchise Relationship Laws

The state franchise relationship laws take another approach to protecting franchisees. These laws impose substantive requirements that typically limit the franchisor's ability to terminate or refuse to renew without good cause. Rather than regulating disclosures at the time franchises are sold, these laws regulate the relationship between the franchisor and franchisee after the sale.

In 1964, Puerto Rico was the first U.S. jurisdiction to enact a law requiring good cause to terminate a dealership or a franchise. A number of other states followed Puerto Rico's lead, enacting franchise relationship laws of their own. The first was the New Jersey Franchise Practices Act, enacted in 1971. The Wisconsin Fair Dealership Law was enacted in 1974. Today, the following eighteen states (in addition to Puerto Rico) have laws of general applicability that govern the franchise relationship:

Arkansas	Minnesota
California	Mississippi
Connecticut	Missouri
Delaware	Nebraska
Hawaii	New Jersey
Illinois	Rhode Island
Indiana	Virginia
Iowa	Washington
Michigan	Wisconsin

What does "good cause" mean? What does it mean to require "good cause" for termination and nonrenewal? That depends on the state and its particular statute, as well as the local courts. It may mean simply the franchisee's failure to comply substantially with the franchisor's requirements. Most of these state laws do not give a clear definition of "good cause" except by stating a few examples, leaving it often to the courts to determine whether good cause exists.

In addition to the good cause requirement, the franchise relationship laws contain procedural requirements for termination and nonrenewal. Before a franchisor terminates a franchise, these laws may require that the franchisor give the franchisee a specific minimum notice period and an opportunity to cure before terminating the franchise agreement, regardless of what the franchise agreement provides. These laws may also require a minimum notice period in the case of nonrenewal. For example, in California and Iowa, a franchisor must give the franchisee at least 180 days' notice of the franchisor's intention not to renew the franchise. The state of Washington requires a full year's notice of nonrenewal.

F. Business Opportunity Laws

Another set of laws that affect franchising are those laws that regulate "business opportunities." Half of the states have business opportunity laws. What is a business opportunity? The definition varies widely from one state to the next. Sometimes, a business opportunity is like a franchise without a trademark. In most cases, what you say in the course of the sales process determines whether it falls within the scope of a business opportunities law. The seller of a business opportunity sells the buyer a package of equipment or inventory or both, and makes certain representations to the buyer. The seller may represent that it will find customers for the buyer's products or services, or that the seller will purchase the products made using the equipment sold to the buyer, or that the seller guarantees that the buyer will derive income from the opportunity.

Suppliers of vending machine and rack display resale opportunities commonly fall under the business opportunity laws. In one case, an educational seminar in which the sponsor sold products and services that would enable purchasers to operate as brokers or factors was found to be a business opportunity under Connecticut law where the sponsor offered a no-risk guarantee under which a purchaser could receive a full refund if he failed to earn a profit within a stated period of time. [4]

Like the franchise laws, the business opportunity laws contain disclosure requirements and sometimes require a filing. Unlike the state disclosure requirements, which are largely uniform throughout the U.S., the business opportunity law disclosure requirements vary from state to state.

The business opportunity laws generally contain exceptions or exemptions for franchise offerings made in compliance with the FTC Rule, and many of these laws exempt offerings that include rights relating to a federally registered trademark. Even with these exceptions and exemptions, certain states will require a filing. Florida requires a simple exemption filing for franchisors. In Connecticut, an offer of a franchise without a federal trademark registration will constitute an offer of a business opportunity unless some other exemption or exclusion applies. Once the mark is registered, a franchise offering is exempt under the business opportunity law in Connecticut, but the franchisor is nevertheless required to notify the state of its offering that is exempt. Texas requires a business opportunity exemption filing regardless of whether the franchisor's trademark is registered. Kentucky, Nebraska and Utah may also require franchisors to make business opportunity filings. Other states where the business opportunity laws may apply to franchise offerings involving unregistered trademarks are Georgia, Louisiana, Maine, North Carolina and South Carolina.

G. Federal Regulation of Business Opportunities

At the federal level, the FTC began regulating the sale of business opportunities in 1979. The initial business opportunity rule was a part of the 1979 FTC Rule. In 2006, the FTC issued a notice of proposed rulemaking with respect to a proposed trade regulation rule on business opportunities to replace the 1979 rule.[5] The staff report was issued in 2010.[6] The FTC has not yet issued a new rule.

While franchising has become a respectable mode of doing business, fraud and deception persist in the realm of business opportunities. In its press release announcing the proposed rulemaking on April 5, 2006, the FTC wrote that it had brought more than 200 enforcement actions against business opportunities since its rule took effect in 1979. Between 1995 and 2006,

---

[4] *Connecticut Department of Banking, Securities and Business Investments Division* (1994) Bus. Franchise Guide ¶10,424.

[5] *See* Business Opportunity Rule, 71 Fed. Reg. 19,054, 19,056 (Apr. 12, 2006), *available at* www.ftc.gov/opa/2006/04/newbizopprule.shtm. If adopted, the rule will be codified at 16 C.F.R. Part 437.

[6] *See* www.ftc.gov/os/fedreg/2010/october/101028businessopportunitiesstaffreport.pdf.

the FTC conducted 12 sweeps on business opportunities.[7] The FTC stated that the proposed rule also would prohibit unfair or deceptive practices that are common among fraudulent business opportunity sellers, including:

- misrepresentations about the material terms of the business relationship;
- the use of shills;
- misrepresentations of endorsements or testimonials;
- failure to honor territorial protection guarantees; and
- failure to honor refunds.

The FTC's proposed rule on business opportunities would greatly simplify the disclosures that sellers of business opportunities would be required to make. It would require that business opportunity sellers deliver a one-page disclosure to each prospective buyer at least seven days before the sale. The disclosure would address five items: (i) whether the seller makes an earnings claim; (ii) a list of any criminal or civil legal actions against the seller or its representatives that involve fraud, misrepresentations, securities, or deceptive or unfair trade practices; (iii) whether the seller has cancellation or refund policies and such policies' terms; (iv) the total number of purchasers in the past two years and the number of those purchasers seeking a refund or to cancel in that time period; and (v) a list of references. If the seller provides an earnings claim, the seller must also provide an "Earnings Claims Statement."

At the same time, the definition of a business opportunity would be expanded enormously. A "business opportunity" under the proposed rule means: (i) a solicitation to enter into a new business; (ii) payment of consideration directly, or indirectly through a third party; and (iii) either an earnings claim or an offer to provide business assistance. This definition is extremely broad. Many businesses that are not now viewed as business opportunities would be covered by the new rule. The current FTC rule applies only to a narrow range of business opportunities, including vending machines or rack displays, coupled with account acquisition or location assistance.

The proposed new rule may also apply to work-at-home businesses, multilevel marketing arrangements, and many traditional dealership and distribution arrangements, including manufacturer's representatives, commissioned sales people, insurance agents and real estate agents.

The new rule would eliminate some of the most common exemptions of the current rule. Under the current rule, investments under $500 are not regulated; but under the proposed rule, there would be no minimum investment requirement. Under the current rule, payments for reasonable amounts of inventory at bona fide wholesale price are exempt; but this exemption would not apply to business opportunities.

The proposed FTC rule would not preempt the right of states to impose additional requirements. For example, many state business opportunities laws require the seller to disclose its financial condition, post a security bond, register its sales people and file advertisements.

[7] See also www.ftc.gov/opa/2011/03/emptypromises.shtm.

Franchisors would be excluded from the new FTC business opportunities rule if their offer meets the definition of a franchise, they have a written contract and require the buyer to make a payment of at least $500.

H. Sanctions for Violations

Being a franchise and not complying with the franchise registration and disclosure laws can be costly. An FTC Rule violation is deemed to be "an unfair or deceptive act or practice" within the meaning of Section 5 of the FTC Act. Violation of the FTC Rule does not give rise to a private right of action. Nevertheless, the FTC is empowered to enforce the FTC Act by seeking permanent injunctions, rescission and restitution in federal court without initiating administrative proceedings. A federal district court may exercise equitable powers and order any relief necessary to make permanent relief possible. Such relief may include an assets freeze, consumer redress and criminal liability.[8]

Failure to comply with the state franchise laws can result in both administrative proceedings and private actions by franchisees for rescission, damages, injunctive or declaratory relief, attorneys' fees, and costs. Where the violation is willful, the state laws allow for punitive damages and impose criminal liability.

Failure to comply with the state business opportunity laws also carries potentially serious sanctions. In Connecticut, for example, the office of the Banking Commissioner stopped a company from continuing to offer and sell licenses and distributorships of their physical fitness programs because of their repeated violations of the Connecticut Business Opportunities Act.[9]

Business opportunity violations can also be costly at the federal level. The FTC brought an action against one company that offered investors the opportunity to sell web pages or advertising space on the company's website, representing that for a fee of almost $3,000, the investor could reasonably expect to make between $2,000 and $20,000 a month while working as little as 5 to 10 hours a week. In fact, few investors actually saw these types of returns. The company settled, paying $4,000,000 for consumer redress, most of which was to be paid personally by the company's co-founders.[10]

---

[8] Consumer redress in one case amounted to more than $9,000,000. FTC v. Jordan Ashley, Bus. Franchise Guide (CCH) ¶10,425 (1994). In another case, an individual charged with conspiracy to violate the FTC Rule was sentenced to three years in prison and ordered to pay $80,500 in restitution. U.S. v. Jaspon, Bus. Franchise Guide (CCH) ¶9773 (1991).

[9] Beverly Hills Concepts, Inc. v. Schatz and Schatz, Ribicoff and Kotkin (CT Superior Court, 1997), Bus. Franchise Guide (CCH) ¶11,099; aff'd (CT Supreme Court, 1998), Bus. Franchise Guide (CCH) ¶11,488.

[10] FTC v. iMall (CD Ca April 15, 1999).

Aside from the legal sanctions, nonlegal risks include the possibility of bad publicity and the consequent loss of business.

I. Violations in New York

A person who sells a franchise in violation of the New York Franchise Act is liable to the purchaser for damages. If the violation is willful and material, the buyer has the right to rescind and collect attorney's fees and costs. [11]

If you find that your client has offered franchises in violation of the New York Franchise Act and your client wants to offer franchises in the future, then the statute prescribe specific steps the franchisor can take essentially to correct the violation.[12] An aggrieved franchisee may not bring a lawsuit against a franchisor for violation of the New York Franchise Act if the franchisor follows the required steps. First, the franchisor will need to prepare a franchise disclosure document and submit it to the Attorney General's Office for registration. At least 10 days later, the franchisor must submit to each franchisee a written offer to refund the consideration paid together with interest at 6% per year from the date of payment, less the amount of income earned by the franchisee from the franchise. If the franchisee accepts the offer, the franchisee must tender all items the franchisee received for the consideration and not sold. If the franchisee does not accept the offer within 30 days, the franchisee may not bring a lawsuit for violation of the Act.

Officers and directors can be personally liable for violations of the New York Franchise Act.[13] The statute of limitations in any private lawsuit under the act is three years from the act or transaction constituting the violation.[14]

The Department of Law can prosecute a violation of the New York Franchise Act as a criminal offense and can seek restitution for fraudulent practices. [15]

III. THE SCOPE OF THE FRANCHISE LAWS

A. How Do the Laws Define a "Franchise"?

The answer to the question of whether a particular business is a "franchise" sometimes requires a close analysis of the facts and the law, and the answer may vary from state to state. What then is a franchise?

---

[11] Section 691(1) of the New York General Business Law.

[12] Section 691(2) of the New York General Business Law.

[13] Section 691(3) of the New York General Business Law.

[14] Section 691(4) of the New York General Business Law.

[15] Section 692 of the New York General Business Law.

Definition of a Franchise under the FTC Rule

The FTC Rule defines the term “franchise” to include 4 elements:[16]

(1) a continuing commercial relationship
(2) a trademark
(3) a fee
(4) significant control or assistance

Trademark – The trademark element is satisfied if the franchisee operates under the franchisor’s trademark or service mark or distributes goods or services associated with the franchisor's trademark or service mark. There is no need for a license or grant of trademark rights. The threshold for the trademark requirement is very low. The FTC’s brief discussion of the trademark element in its “Interpretive Guides to Franchising and Business Opportunity Ventures Trade Regulation Rule” (the “Interpretive Guides”) [17] include the following explanation:

> The Commission does not intend to cover package or product franchises in which no mark is involved. If a mark is not necessary to a particular distribution arrangement, the supplier may avoid coverage under the rule by expressly prohibiting the use of its mark by the distributor.[18]

In other words, if a product or service sold by a distributor is identified by the supplier’s mark, the only way to be sure to avoid meeting the trademark element is by including in the distribution agreement an express prohibition of the use of the mark by the distributor. In fact, the mere possibility that a distributor can use the supplier’s trademark suffices for purposes of the trademark element of the definition of a franchise under the FTC Rule.[19]

Control or Assistance – The control or assistance element is satisfied if the franchisor (a) exerts or has authority to exert a significant degree of control over the franchisee’s method of operation, or (b) gives significant assistance to the franchisee in the franchisee’s method of operation. The FTC explained this requirement as follows in its Interpretive Guides:

> The term “significant” relates to the degree to which the franchisee is dependent upon the franchisor’s superior business expertise – an expertise made available to

[16] See the appendix for the FTC Rule definition of a “franchise”.

[17] Bus. Franchise Guide (CCH) ¶ 6201 et seq., 44 *Fed. Reg.* 49966 (Aug. 24, 1979).

[18] Bus. Franchise Guide (CCH) ¶ 6205, 44 *Fed. Reg.* 49966 (Aug. 24, 1979).

[19] *Informal FTC Staff Advisory Opinion to U.S. Marble, Inc.*, Bus. Franchise Guide (CCH) ¶ 6424 (1980).

> the franchisee by virtue of its association with the franchisor. The franchisee, in order to reduce its business risks or enhance its chances for business success, relies upon the availability of such expertise to avoid business mistakes that it otherwise might make. The franchisor conveys its expertise either by exercising controls over the franchisee's method of operation of the business or by furnishing assistance to the franchisee in areas relating to the franchisee's method of operation. If the controls over or assistance to the franchisee's method of operation of the business are "significant", then this second element of the rule's definition is met.
>
> Among the significant types of controls over the franchisee's method of operation are those involving a) site approval for unestablished businesses, b) site design or appearance requirements, c) hours of operation, d) production techniques, e) accounting practices, f) personnel policies and practices, g) promotional campaigns requiring franchisee participation or financial contribution, h) restrictions on customers, and i) location or sales area restrictions.
>
> Among the significant types of promises of assistance to the franchisee's method of operation are a) formal sales, repair or business training programs, b) establishing accounting systems, c) furnishing management, marketing or personnel advice, d) selecting site locations, and e) furnishing a detailed operating manual.[20]

The FTC went on to say that the presence of "any" of the elements listed above "would suggest the existence of "significant control or assistance." In so doing, the FTC diminished the importance of the word "significant" in this definitional element.

Fee – The fee element is satisfied if the franchisee is required to make a payment of at least $500 to the franchisor (or an affiliate of the franchisor), at any time before to within six months after commencing operation of the franchised business, as a condition of obtaining or commencing the franchise operation. This payment need not be in the form of a franchise fee or royalties on sales. It may be a required payment for rent, equipment and supplies, training or other items. The FTC explained this requirement as follows in its Interpretive Guides:

> The Commission's objective in interpreting the term "required payment" is to capture all sources of revenue which the franchisee must pay to the franchisor or its affiliate for the right to associate with the franchisor and market its goods or services. Often, required payments are not limited to a simple franchise fee, but entails other payments which the franchisee is required to pay to the franchisor or an affiliate, either by contract or by practical necessity. Among the forms of required payments include initial franchise fees as well as those for rent, advertising assistance, required equipment and supplies – including those from third parties where the franchisor or its affiliate receives payment as a result of such purchases – training, security deposits, escrow deposits, non-refundable

[20] Bus. Franchise Guide (CCH) ¶ 6206, 44 *Fed. Reg.* 49966 (Aug. 24, 1979).

bookkeeping charges, promotional literature, payments for services of persons to be established in business, equipment rental, and continuing royalties on sales.[21]

Definition of a Franchise under the State Franchise Sales Laws

The definitions of a “franchise” under the state franchise sales laws are similar to the FTC definition of a “franchise”.[22] These definitions commonly contain the following elements

(1) the grant of a right to engage in a business
(2) under a trademark
(3) for a fee
(4) in conjunction with a marketing plan prescribed in substantial part by the franchisor

The trademark and fee elements of the state laws are parallel to the FTC Rule. However, instead of “control or assistance,” the state laws generally refer to a “marketing plan or system prescribed in substantial part by a franchisor ....” Under most of these laws, all of the elements must be present in order for the arrangement to constitute a franchise.

Of all the state franchise disclosure laws, the one with the broadest definition of a franchise is New York. The definition of a franchise in New York includes a required fee and either a trademark or a marketing plan element, not both.[23] In New York, elimination of either the marketing plan element or the trademark element will not suffice to avoid application of the New York franchise sales law. Moreover, the New York franchise law can apply extraterritorially, as discussed below. The New York franchise law applies if the offer merely originates from New York or is accepted in the state, regardless of where the franchisee or the franchised business is located.

Definition of a Franchise under the State Franchise Relationship Laws

Several of the state franchise relationship laws also define a franchise as containing a trademark element, a fee element and a marketing plan element.[24]

Some of the franchise relationship laws do not include a marketing plan element in their definition of a franchise, but rather require that there be a “community of interest” between the franchisor and franchisee. States with this type of definition of a franchise include New Jersey

[21] Bus. Franchise Guide (CCH) ¶ 6207, 44 *Fed. Reg.* 49966 (Aug. 24, 1979).

[22] A typical example of a franchise disclosure law is the California Franchise Investment Law. See Appendix.

[23] Section 681 of the New York General Business Law. See Appendix.

[24] *See, e.g.,* Connecticut Franchise Act, Conn. Gen. Stat. Ann. §42-133e. See Appendix.

and Wisconsin, among others.[25] The definition of a "community of interest" can be extremely broad.

In fact, a number of the franchise relationship laws cover not just franchises, but many dealerships and distribution arrangements as well. Manufacturers and suppliers who enter into agreements with distributors, wholesalers or retailers in Arkansas, Connecticut, Missouri, New Jersey or Wisconsin must be particularly careful. The relationship laws of these states define the term "franchise" without a fee element. Courts have held dealership and distribution arrangements to be franchises under the relationship laws of Indiana,[26] Missouri[27] and New Jersey.[28] A license to manufacture and sell a product was held in one case to be within the scope of the Connecticut Franchise Act, a franchise relationship law, because the licensor imposed wide-ranging requirements.[29]

Definition of a "Business Opportunity"

While the business opportunity laws vary from state to state, these laws generally define a business opportunity broadly.[30] The representations made in conjunction with the marketing and sale of the business opportunity are central to the question of the coverage under these laws. Aside from rack display and vending machine sales, these laws often come into play when the

---

[25] See Appendix for the definitions in New Jersey and Wisconsin.

[26] *Wright-Moore Corp. v. Ricoh Corp.*, 908 F.2d 128 (7th Cir. 1990), *aff'd*, 980 F.2d 432 (7th Cir. 1992) (holding that a photocopier distributor was protected from nonrenewal by the Indiana Deceptive Franchise Practices Act).

[27] *See American Bus. Interiors, Inc. v. Haworth, Inc.*, 798 F.2d 1135 (8th Cir. 1986) (holding that an office furniture dealer was protected from termination by the Missouri Franchises Law).

[28] *Instructional Systems, Inc. v. Computer Curriculum Corp.* No. 93-5414 (3d Cir. Sept. 16, 1994) (slip opinion), *cert. denied*, 63 U.S.L.W. 3477 (February 21, 1995) (holding a distributor to be a franchise even though the distributor operated under its own name); *Carlos v. Philips Bus. Sys., Inc.*, 556 F. Supp. 769 (E.D.N.Y. 1983), *aff'd in part and rev'd in part*, 744 F.2d 287 (2d Cir. 1984) (holding that a distributor of dictation machines was protected from termination by the New Jersey Franchise Practices Act).

[29] In *Chem-Tek, Inc. v. General Motors Corp.*, 816 F. Sup. 123 (D. Conn. 1993) (holding that the marketing plan element of the definition of a franchise was satisfied where GM, the licensor of a manufacturer of vehicle protection products, directed the employment of the licensee's marketing personnel and retained authority to approve or direct their termination; reimbursed salaries and expenses for marketing personnel; set the purchase price for the products; and prohibited the licensee from offering any competing products.

[30] The California law is one example. See the appendix.

seller represents that it will purchase the products made using the goods or services sold to the purchaser, or the seller guarantees in writing that the purchaser will derive income from the opportunity. For example, an educational seminar in which the sponsor sold products and services that would enable purchasers to operate as brokers or factors was found to be a business opportunity under Connecticut law, where the sponsor offered a no-risk guarantee under which a purchaser could receive a full refund if he fails to earn a profit within a stated period of time.[31]

B. Jurisdictional Scope of the Franchise Sales Laws

Most of the state franchise sales laws apply in the event of an "offer" or "sale" of a franchise in the state. Such laws apply if (i) the offer originates from the state, (ii) is received or accepted in the state, or (iii) is made to a domiciliary of the state.

In some situations, the franchise sales laws of more than one state may apply to the same franchise offering. This may happen, for example, when the franchisee is a company with its principal office in one state, while the franchised business is in another state. The law of the state in which the franchisee's principal office is located may apply where an offer is accepted in that state. The law of the state in which the franchise business is located may also apply. In addition, the law of the franchisor's state may apply where the offer originates from that state. For example, an offer by a New York franchisor to a resident of Indiana for a franchise to be located in Virginia may be subject to the requirements of the franchise laws of New York, Indiana and Virginia. This raises problems where the application of these laws results in conflicts. Registration states often require minor variations in franchise disclosure documents.

This jurisdictional problem has become less important over the years. Some states, such as California, specifically exclude out-of-state franchise locations from the coverage of their franchise disclosure laws.

Unlike California, New York does not limit the application of its franchise sales law to offerings of franchises physically located within the state. The New York Franchise Act specifically states that an offer to sell is made in the state "when the offer either originated from this state or is directed by the offeror to this state and received at the place to which it is directed." The extraterritorial application of the Act was upheld in at least one case, *Mon-Shore Management v. Family Media,*[32] where the court applied the New York Franchise Act when the offer merely originated in New York, even though the offerees and the franchised businesses were outside the state. The lesson from this is that if your company is based in New York, you should not offer franchises in any state unless you are registered in New York.

The disclosure requirements are primarily federally mandated and the states that regulate franchise sales have worked to minimize state variations and present uniform state requirements. While some states impose specific requirements that go beyond the federal disclosure

---

[31] *Connecticut Department of Banking, Securities and Business Investments Division* (1994) Bus. Franchise Guide ¶10,424.

[32] 584 F. Supp. 186 (S.D.N.Y. 1984), Bus. Franchise Guide ¶8150.

requirements, franchisors today commonly combine the requirements of several states into one franchise disclosure document by including "state-specific" addenda.

C. Exemptions and Exclusions

Franchise Sales Law Exemptions

The exceptions, exemptions and exclusions from coverage under the various franchise disclosure and registration laws vary from state to state. Nevertheless, there are some common threads, including those described in this section.

The FTC Rule and the various state franchise registration and disclosure laws contain a number of exemptions and exclusions. Some exemptions and exclusions are common to a number of these laws. Others may be unique to the FTC Rule or the laws of only one or a few states. In some cases, an arrangement may be exempt from filing or registration requirements but not disclosure requirements. Some exemptions are self-executing. Other exemptions require some type of filing or approval. You must be careful to look at the laws of the relevant states in each instance.

Here are some of the exemptions and exclusions available under the franchise sales laws:

Nominal Fee – Every definition of a "franchise" includes a "fee" element. The FTC Rule excludes from the definition of a franchise "fee" payments of less than $500 required to be made before and within six months after the franchisee opens for business. If no franchise fee is paid, then there is no franchise. Several of the states also have exclusions for small payments on an annual basis.

Bona Fide Wholesale Price – The FTC and all states exclude from the definition of a franchise fee amounts paid for a reasonable quantity of goods sold at a bona fide wholesale price. Under the FTC Rule and the laws of several states, this exclusion only applies to inventory items purchased from the franchisor for resale. It would not cover the purchase of equipment, furnishings, training or other items that do not constitute inventory for resale.

A number of states have specific exclusions for specific types of purchases in addition to inventory. New York, for example, specifically excludes the "purchase of sales demonstration equipment and materials furnished at cost for use in making sales and not for resale" and the "purchase or lease, at fair market value, of real property … necessary to enter into the business … under the franchise agreement."[33]

Fractional Franchise – The FTC Rule exempts "fractional franchises". To the extent that the business offered is a mere adjunct to a customer's existing business, the offered business may constitute a "fractional franchise" under the FTC Rule. The exemption for "fractional franchises" is available under the FTC Rule only if the franchisee or any of its directors or

[33] NY. Gen. Bus. Law §681.1(7).

executive officers has had more than two years of prior management experience in the business represented by the franchise and the parties anticipate at the time of entering into the agreement that sales under the agreement will represent no more than 20% of the dollar volume of the franchisee's projected gross sales within the reasonably foreseeable future.

A few states also have fractional franchise exemptions. New York exempts fractional franchises by regulation. In those states that do not have explicit fractional franchise exemptions by statute, a fractional franchise may fail to meet the definitional requirement of a grant of the right to engage in a business.

Although there is no “fractional franchise” exemption under the state franchise relationship laws, courts in some states have held that “multiline” distribution arrangements, where sales of the products of the alleged “franchisor” account for only a fraction of the distributor’s total sales, lack one or more elements of the definition of a franchise under the state franchise relationship laws. In New Jersey, the definition of a franchise specifically includes a 20% requirement similar to the FTC Rule. In other words, a business that would be a “fractional franchise” under the FTC Rule is unlikely to be a franchise for state law purposes.

Large Investments – The FTC Rule exempts large investments. Disclosure is not required if: (1) the estimated investment exceeds $1 million, excluding (a) financing from the franchisor or its affiliate, and (b) real estate costs, and (2) the franchisee signs an acknowledgment verifying the grounds for the exemption. Maryland and Wisconsin also exempt large investments.

Large Franchisees – The FTC Rule also exempts large franchisees. This exemption applies if the prospective franchisee has been in business for 5 years and has a net worth of at least $5 million. California, Rhode Island and Washington also exempt large franchisees.

Franchisor Insiders – The FTC Rule also exempts franchisor insiders. This exemption applies if one or more purchasers with combined ownership of at least 50% has either (1) two years of management responsibility for the sale of the franchisor’s franchises or the administration of the franchised network, or (2) for two years has been an owner of at least 25% of the franchisor. California also exempts franchisor insiders.

Large Franchisor – Several states exempt sales made by large franchisors. For example, California exempts offers by a franchisor with a net worth of at least $5,000,000 which either has had twenty-five franchisees conducting business during the last five years or has conducted the business which is the subject of the franchise for at least five years. In New York, such a large franchisor may apply for an exemption; but the exemption is automatic only if the franchisor has a net worth of at least $15,000,000.

Sale by a Franchisee – The FTC Rule specifically exempts franchise resales, as do the franchise laws of several other states. These states include California, Hawaii, Illinois, Indiana, Maryland, Minnesota, North Dakota, Rhode Island, South Dakota, Washington and Wisconsin. Only New York specifically requires a franchisee to make disclosures to the prospective buyer of its business. Section 684.5 of the NYFA exempts the offer or sale of a franchise by a franchisee for his own account.[34] Practically speaking, most franchisors become involved in the process of approving the transferee and ask the transferee to sign a new franchise agreement. In such cases, franchisors typically disclose to purchasers.

Out-of-State Sales – Several states have out-of-state sales exemptions. These states include California, Hawaii, Illinois, Maryland, Michigan, Minnesota, Rhode Island and Wisconsin. The FTC Rule specifically exempts the sale of franchises outside the U.S. New York does not have an exemption for international sales or out-of-state sales.

Isolated Sales – The FTC Rule excludes the grant of the right to use a trademark where the license is the only one of its general nature and type to be granted by the licensor with respect to the trademark.[35] A few states also exempt certain isolated sales or limited offers. New York, for example, exempts certain offers directed to not more than two persons as long as the offer did not confer subfranchising rights, no commission is paid and the franchisor is either domiciled in the state or has filed a consent to service of process.

General Partnerships – General partnerships are excluded from the definition of a franchise under the FTC Rule.[36] The question of whether a relationship is one of general partners is a question of fact determined on a case-by-case basis. The FTC examines the nature of each partner's interest. Each partner must be free to exercise control over the partnership business, and one must not have an unfair advantage. The partnership arrangement must be bona fide. This is a difficult test when one partner is licensing the concept to the other.

Whether you call it a general partnership or a joint venture, there is always some risk when one partner licenses the partnership or joint venture. When a licensed outlet is owned in part by the supplier (or licensor) and in part by the operator of the outlet, the arrangement may be a franchise. The fact that the licensor is a part owner may not remove the arrangement from coverage by the franchise laws. If the elements of a franchise are otherwise present, the

---

[34] This exemption has three conditions: (a) The sale must be an isolated sale and not part of a plan of distribution of franchises. (b) It cannot be effected by or through a franchisor. (c) The franchisee must furnish to the prospective purchaser a copy of the offering prospectus of the franchisor currently registered with the Department of Law.

[35] This exclusion is one of four non-franchise relationships that appeared as specific exclusions in the 1970 franchise rule at 16 CFR 436.2(a)(4)(i)-(iv). The four excluded relationships are those that involve: (1) employer-employees and general partnerships; (2) cooperative organizations; (3) testing or certification services; and (4) single trademark licenses. These exclusions are retained in the revised FTC Rule as a matter of policy, although the specific text of the exclusions was removed from the final Rule as part of the FTC's effort to streamline the Rule. See notes 67, 777 and 871 of the Statement of Basis and Purpose and the accompanying text. 72 Fed. Reg. 15,544 (March 30, 2007).

[36] *Id. See* Informal FTC Staff Advisory Opinions 93-3, 93-4 and 01-2, Bus. Franchise Guide (CCH) ¶¶ 6447, 6448 and 6510.

arrangement will be a franchise. The risk of being a franchise is the greatest if the licensor makes no investment in the business other than the grant of the license. Even with an equity investment of cash in the enterprise, there is some risk that the business may be a franchise.

Other Exemptions and Exclusions – The FTC Rule and the various state laws contain a number of other specific exemptions and exclusions. These include leased departments in retail stores where the seller occupies space within a larger store, typically a department store, and sells its own products. Others arrangements that are outside of the scope of these laws include cooperatives and employment relationships.[37]

Statute of Limitations – Many of the state franchise laws have specific statutes of limitations. In New York, for example, rescission is available if the violation is willful. However, the remedy of rescission is subject to a three-year statute of limitations.[38]

Business Opportunity Law Exemptions

Many business opportunity laws have exemptions for arrangements that fall within the scope of the franchise laws. In many cases, a company can avoid the business opportunity laws simply by registering its trademarks. Connecticut, for example, has an exclusion from the definition of a business opportunity where the offer of a marketing program is made in conjunction with the licensing of a federally registered trademark, provided that the seller files with the state a copy of the trademark certificate before any offer or sale is made in Connecticut.

D. Cases Defining a "Franchise"

Over the years, many courts have interpreted the meaning of the term "franchise" under the various state laws. We cite just a few of them here to highlight the contours of the definition.

New York Cases

The New York State Attorney General's office will not hesitate to prosecute a company that is franchising without complying with the state's franchise law.

In June, 2000, the state Attorney General's office announced a settlement with the owner of Tiger Schulmann's Karate Centers, the state's largest chain of karate schools.[39] The Attorney General's position was that the centers were franchises because they paid franchise fees, taught the same style of karate, used the same logos and pooled their monies for advertising. The owner agreed to pay $195,000 in penalties and costs and to comply with the New York state franchise law. He agreed to register the chain as a franchise and provide franchisees a copy of

---

[37] *Supra* note 30.

[38] NY GBL § 691(4).

[39] *See* "Settlement with New York State's Largest Karate School Chain Ends Deceptive Practices," www.oag.state.ny.us/press/2000/nov/nov27a_00.html (Press Release, Nov. 27, 2000).

the company's franchise disclosure document. In addition, he agreed to give franchisees the right to rescind their agreements.

In New York, black car and limousine services have been held to be franchises. The initial case that so held involved a company called Aristacar Corp.[40] Aristacar owned and operated a non-medallioned radio dispatch car service licensed by the City's Taxi and Limousine Commission. The company was also licensed by the FCC to operate over a two-way radio frequency. Aristacar sold license rights to drivers for a fee and service charge. Under these the agreements with the drivers, the company served as a base from which the two-way radio network operated, furnished radio equipment and procured customers which were allotted to the drivers through Aristacar's bidding system. The drivers operated their own automobiles, although the brand, style and age of the permitted cars were defined in the agreement. Drivers were required to affix the Aristacar logo to their vehicles to enable the customers to identify the vehicles when they arrived at the pick-up locations.

One court held that the New York franchise law applied to exclusive distributorships for beepers that transmitted sports information. In that case, distributors paid an initial fee and ongoing service fees. The defendant's trademark, "Beeper Plus", was disseminated by radio on the beeper screens.[41]

As broad as the New York franchise law is, it does have limits. In one New York case, the court held that a distribution arrangement was not a franchise when the plaintiff bought the alleged franchise from a distributor rather than from the supplier.[42] The seller sold the right to purchase bakery goods at wholesale directly from a bakery, and to distribute them in a specified area. The bakery then went out of business and the buyer sought to rescind the purchase agreement based on an alleged violation of the New York franchise law. The court held this was not a franchise because the buyer paid no franchise fee to the bakery and the bakery did not regulate or control the buyer's sales activities.

While violation of the New York franchise law may give rise to a right of rescission, it does not extinguish all contract rights. In one case, although a radio-dispatch car service operator failed to comply with the New York franchise law, the court declined to dismiss the company's action against the former franchisees and a competitor for breach of contract and tortious interference with contractual relations.[43]

---

[40] *Aristacar Corp. v. Attorney General of the State of New York,* Bus. Franchise Guide (CCH) ¶9369 (1989).

[41] King Computer, Inc. v. Beeper Plus, Inc., Bus. Franchise Guide (CCH) ¶10,182 (1993).

[42] Charles Kennedy v. Dominick Lomei, Bus. Franchise Guide (CCH) ¶10,048 (1991)

[43] *TKO Fleet Enterprises, Inc. v. Elite Limousine Plus, Inc.,* Bus. Franchise Guide (CCH) ¶11,855 (2000). *See also Moseley's & Co. v. The Maxim Group, Inc.,* Bus. Franchise Guide

Distributors, Dealers and Sales Representatives

In just a few cases, courts have also found some distributorship arrangements to constitute franchises under the registration and disclosure laws of some states, including Indiana,[44] Minnesota[45], North Dakota[46] and Washington.[47] Most distributorship arrangements are not franchises for purposes of the franchise registration and disclosure laws.

A sales representative agreement is generally regarded as not being a franchise. The FTC's 1979 Interpretive Guides indicate that agents compensated by commission are generally not franchisees: "Agency relationships in which independent agents, compensated by commission, sell goods or services (*e.g.* insurance salespersons) are excluded, since there is no 'required payment.'" [48] However, a California appellate court held that an agreement whereby the plaintiff solicited orders on behalf of the defendant was in fact a "franchise" within the meaning of the California Franchise Investment Law (a registration and disclosure law).[49] The court so held even though all orders were subject to acceptance by the manufacturer, who set prices and terms of sale, billed customers, and received customer payments. The court noted that, in addition to soliciting orders, the plaintiffs demonstrated products, solved customer problems, installed systems, maintained contact with existing customers, generated new business, and provided ongoing service to customers. This description is not terribly different from the role that most sales representatives play.

(CCH) ¶11,664 (1999) (holding that a contract was not void ab initio under the Illinois Franchise Disclosure Act when the franchisor had not complied with the requirements of the law).

[44] *Master Abrasives Corp. v. Dean Williams*, 469 N.E. 2d 1196, Bus. Franchise Guide (CCH) ¶8248 (Ind App. 1984) (holding an equipment distributorship to be entitled to damages and attorneys' fees for misrepresentation upon the sale of the franchise under Indiana law).

[45] *Chase Manhattan Bank, N.A. v. Clusiau Sales & Rental, Inc.*, 308 N.W.2d 490 (Minn. 1981) (holding that a muffler dealer was entitled to rescind its lease because the dealership and lease had been offered in violation of the Minnesota Franchises Law).

[46] *Meadow Fresh Farms, Inc. v. Sandstrom,* 333 N.W.2d 780 (N.D. 1983) (granting the North Dakota Securities Commissioner a cease and desist order against the offering of distributorships for the sale of dry milk because they were deemed to be unregistered franchises in violation of the North Dakota Franchise Investment Law).

[47] *Lobdell v. Sugar 'N Spice, Inc.*, 33 Wash. App. 881, 658 P.2d 1267 (1983) (holding that a candy distributor was entitled to seek treble damages and attorneys' fees because its distributorship had been offered in violation of the Washington Franchise Investment Act).

[48] Bus. Franchise Guide (CCH) ¶ 6207, 44 *Fed. Reg.* 49966 (Aug. 24, 1979).

[49] *Gentis v. Safeguard Bus. Sys., Inc.,* 60 Cal. App. 4th 1294, 71 Cal. Rptr. 2d 122 (1998).

In one case, a former distributor of Whirlpool appliance parts claimed that Whirlpool Corporation had violated the Michigan Franchise Investment Law by failing to approve the proposed sale of the distributor's business. The court held that the plaintiff was not a franchise under the Michigan Franchise Investment Law because the distribution agreement did not prescribe a marketing plan or system.[50]

In staff advisory opinions, the FTC agreed with automobile companies that their dealerships were generally not franchises because there was no franchise fee. The auto manufacturers sold products for resale at bona fide wholesale prices. The FTC has also granted specific exemptions to auto companies for the additional reason that the prospective franchisees are knowledgeable, experienced investors making substantial investments.

The revised FTC Rule specifically exempts franchise relationships covered by the Petroleum Marketing Practices Act. Before it issued the revised Rule, the FTC had exempted most gas stations from the FTC Rule on the basis that they are already covered by the federal Petroleum Marketing Practices Act. Gas station leases are also generally deemed not to be franchises under state law,[51] but can be franchises if the lessor imposes significant controls.[52] Significant controls may include control over hours and days of operation, advertising, financial support, auditing of books, inspection of premises, control of lighting, employee uniforms, prices, hiring, sales quotas and management training.

> [50] SLAP [the distributor] was expected to develop a marketing plan, but to do so on their own. Whirlpool never dictated the form or content of a SLAP marketing plan. Furthermore, Whirlpool states that it had very little control over SLAP's decision-making process. SLAP had the right to sell Whirlpool parts to any buyer in the United States. SLAP also had the right to train their personnel in any manner that they chose. Finally, Whirlpool states that it could not dictate how SLAP was to manage its day-to-day operations.

James v. Whirlpool Corporation, 806 F.Supp. 835, 842 (E.D. Missouri 1992).

[51] *See Consumers Petroleum of Connecticut, Inc. v. Duhan*, 38 Conn. Supp. 495, 452 A.2d 123, Bus. Franchise Guide (CCH) ¶7906 (Conn. Super. Ct. 1982).; *Narumanchi v. Shell Oil Co.,* Bus. Franchise Guide (CCH) ¶8720 (D. Conn. 1986). *See also Ackley v. Gulf Oil Corp.,* 726 F. Supp. 353 (D. Conn.), aff'd, 889 F.2d 1280 (2d Cir. 1989), cert. denied, 494 U.S. 1081 (1990); and *Koehler Enterprises, Inc. v. Shell Oil Co.,* Bus. Franchise Guide (CCH) ¶10,252 (D. Md. 1993); *Robert Sorisio, d/b/a Connecticut Handbag and Luggage Co. v. Lenox, Inc., successor to Hartmann Luggage Co.,* Bus. Franchise Guide (CCH) ¶9360 (D Conn. 1988).

[52] *Atlantic* Richfield *Co. v. Razumic,* 480 Pa. 366, 390 A.2d 736 (1978). *Arnott v. American Oil Co.,* 609 F.2d 873 (8th Cir. 1979), cert. denied, 446 U.S. 918, 100 S. Ct. 1852, 64 L. Ed. 2d 272 (1980); *Shell Oil Co. v. Marinello,* 63 N.J. 402, 307 A.2d 598 (1973), cert. denied, 415 U.S. 920, 94 S. Ct. 1421, 39 L. Ed. 2d 475 (1974).

Other Sales Arrangements

Consignment arrangements are generally not regarded as franchises. In one example, a court held that the agreement under which Pepperidge Farm granted consignees the exclusive right to distribute Pepperidge Farm consigned products to retail stores in specified territories did not constitute franchises under the Washington Franchise Investment Protection Act. The basis of the decision was that no franchise fee was paid.[53]

One court held that an Internet company that assisted auto dealerships to sell their cars was not a franchise under the Michigan Franchise Investment Law. Auto-By-Tel provided auto dealerships with a means of selling their vehicles to a wider range of potential buyers over the Internet. The court regarded the dealership as ABT's customer rather than its franchisee.[54] Auto-By-Tel required subscribing dealerships to train one employee as an "Auto-By-Tel representative," dictated the length of time that dealerships were to leave an offered price on the table, and closely scripted the interactions between dealerships and the referred customers. The court held that these factors were not sufficient to constitute a marketing plan. The court noted that Auto-By-Tel exercised no control whatsoever over the day-to-day business decisions of subscribing dealerships. The dealerships set their own hours of operation, hired and trained employees subject to their own policies, and set their own sales goals. In addition, Auto-By-Tel conducted no audits of the books of the dealerships because these dealerships functioned independently of Auto-By-Tel.

A collection agency "franchisor" that provided a structure for the sharing of the amounts collected among the customer, the alleged "franchisee" and the "franchisor" was held not to be a franchise under the Michigan Franchise Investment Law. The court held there was no marketing plan because the alleged franchisor did not assist the "franchisee" in the affirmative act of selling its services.[55]

E. Avoiding the Franchise Laws

Does it matter what the parties call the relationship?

A business relationship that satisfies the definitional elements of a "franchise" under the FTC Rule is a "franchise" under the Rule regardless of what the parties call it. The definition of a "franchise" under the revised rule specifically refers to a "continuing commercial relationship

---

[53] Atchley v. Pepperidge Farm, Inc., Bus. Franchise Guide (CCH) ¶13,33 (E.D. Washington, March 20, 2006).

[54] In *Jerome-Duncan, Inc. v. Auto-ByTel,* LLC, Bus. Franchise Guide (CCH) ¶11,667 (6th Cir., May 21, 1999), the dealer alleged that ABT could not terminate the agreement without good cause because the arrangement constituted a "franchise" under the Michigan Franchise Investment Law.

[55] *Account Services Corporation v. Dakcs Software Services, Inc.*, 208 Ill. App.3d 392, 398 (1990).

or arrangement, whatever it may be called ….”[56] Similarly, at least one court has held that the label the parties give to the relationship does not preclude the finding of a "franchise" under New York law.[57]

Ways to Avoid the Franchise Laws

One way to be sure that a retail operation with multiple outlets is not a franchise is to open nothing other than company-owned stores. This approach avoids the cost of franchise compliance and the risks of noncompliance. If the arrangement or planned arrangement looks like a franchise, however, here are some ways that the client might change its approach in order to avoid being a franchise:

- Approach dealers with established businesses and offer the product as an addition to the dealers' preexisting businesses. This will frequently fall within the "fractional franchise" exemption of the FTC Rule and similar exemptions or case-law exclusions in most states.

- Enter into a strategic alliance with a company that already has a chain of outlets. Your client would simply supply the product or service, and the other company would find the ultimate customers. This can provide instant expansion at a low cost and without franchise compliance issues.

- Refrain from charging any fees until after the franchisee has been in business for at least six months, or keep the fees under $500 during this initial period. It does not matter how high the fees or royalties are after the first six months. This will bring the arrangement out from under the requirements of the FTC Rule, but will not work in states with franchise sales laws.

- Refrain from charging any fees or royalties whatsoever. This approach can work for a company that simply wants to distribute its products. Like Benneton or Hallmark, it can grant royalty-free licenses to retail stores and sell reasonable amounts of merchandise to the stores for resale. The seller must be sure to sell its products to the stores at bona fide wholesale prices.

- Expressly prohibit the distributor's use of your company's trademark. Instead of a royalty-free license, the agreement would explicitly state that there is no license. For example, the company might offer consulting or management services without licensing a trademark. This approach will not meet the business objectives of all clients. Also, it may not suffice to exclude the application of New York law. Finally, it will not avoid many of the business opportunity laws.

---

[56] See appendix.

[57] *Aristacar Corp. v. Attorney General of the State of New York,* Bus. Franchise Guide (CCH) ¶9369 (1989).

- Exclude the marketing plan element for state purposes and significant control or assistance from a federal point of view. This approach will not suffice to avoid application of the New York franchise law.

- Make the marketing plan entirely optional, leaving purchasers free to run their businesses as they like. The marketing plan as a component of the definition of a franchise must generally be "prescribed" in substantial part by the franchisor. There would also need to be no "significant assistance" for purposes of the FTC Rule.

Conversions and Other Considerations

What about "conversion" franchises? In other words, if a franchisor sells a real estate brokerage franchise to a company that is already a real estate brokerage firm, does that sale constitute the sale of a franchise? In that case, the purchaser is affiliating itself with the franchisor, and the purchase does not have the appearance of the grant of a right to do business. Companies that are already selling franchises typically comply with the franchise disclosure requirements in these cases. However, there is some authority to indicate that such a sale might be exempt as a fractional franchise where the parties do not anticipate the incremental increase in sales resulting from the conversion to exceed 20%.[58]

A company that wants to try out franchising with a single franchisee as a test case before fully complying with the franchise laws will be outside of the scope of the FTC Rule and some of the state laws.

A new franchisor might want to avoid offering franchises in a state that requires registration or disclosure. Even if disclosure is required because the arrangement falls under the FTC Rule, avoiding states with franchise laws will help minimize costs, since the FTC Rule does not require registration. Companies that expect to expand eventually into registration states will gain valuable experience in nonregistration states.

Choice of law clauses will usually not be sufficient to exclude the application of a franchise law that would otherwise apply. However, in some cases, a well-drafted clause may make a difference. If the franchise laws of the contractually selected state would not otherwise apply to the transaction, then it is helpful to state specifically that the choice of that state's law is not intended to include the application of the state franchise law if it would not apply otherwise. It is much more difficult to exclude the application of the franchise law of a state with which the transaction may have some connection. States commonly apply their local franchise laws to offers and sales made in the state as a matter of fundamental policy, regardless of the contractual choice of law.

If the proposed arrangement might arguably be a franchise, consider seeking advisory opinions or discretionary exemptions. Discretionary exemptions are available in New York, for example. At one time, the FTC was issuing advisory opinons with respect to the FTC Rule, but it appears that they are no longer doing so.

[58] Bus. Franchise Guide (CCH) ¶¶6495, 6477.

If the offer may appear to be a business opportunity, be careful not to make any specific representations about the likelihood of success or the amount of money that a prospective buyer can earn from the business venture. The best approach would be not to state at all that the licensee or customer can earn a profit. The absence of any such representation would substantially lessen the risk of being deemed to be a business opportunity under any law. In order to reinforce the position that the offer is not a business opportunity, the grantor should not represent that it will refund the price paid or buy back anything or refund any amounts paid, nor that there is a market for the service. Certainly, the advertising materials should contain no guaranty of profits.

Whatever approach your client plans to take, you will need to look closely at the laws that might come into play. Each one has its own peculiar definitions, exemptions and exclusions.

APPENDIX

DEFINITIONS OF "FRANCHISE"

FTC Rule

Section 436.1(h)

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.

Example Definitions of a "Franchise" under State Franchise Sales Laws

California Franchise Investment Law
§31005(a)

> "Franchise" means a contract or agreement, either expressed or implied, whether oral or written, 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 under a marketing plan or system prescribed in substantial part by a franchisor; and
>
> (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.

New York General Business Law
§681

> "Franchise" means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:
>
> (a) 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, directly or indirectly, a franchise fee, or
>
> (b) 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.

Examples under State Franchise Relationship Laws

Connecticut Franchise Act
Conn. Gen. Stat. Ann. §42-133e

> "Franchise" means an oral or written agreement or arrangement in which (1) 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, provided nothing contained herein shall be deemed to create a franchisor-franchisee relationship between the grantor and grantee of a lease, license or concession to sell goods or services upon or appurtenant to the premises of the grantor, which premises are occupied by the grantor primarily for its own independent merchandising activities; and (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 includes any agreement between a manufacturer, refiner or producer and a distributor, wholesaler or jobber, between a manufacturer, refiner or producer and a retailer, or between a distributor, wholesaler or jobber and a retailer.

New Jersey Franchise Practices Act
N.J. Rev. Stat. §56:10-3

> "Franchise" means a written arrangement for a definite or indefinite period, in which a person grants to another person a license to use a trade name, trade mark, service mark, or related characteristics, and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise.

Wisconsin Fair Dealership Act
Wis. Stat. §135.02(3))

> "Dealership" means a contract or agreement, either expressed or implied, whether oral or written, between 2 or more persons, 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.

Examples under State Business Opportunities Laws

Connecticut
Conn. Gen. Stat. Ann. §36b-61(6)

> "Business opportunity" means the sale or lease, or offer for sale or lease of any products, equipment, supplies or services which are sold or offered for sale to the purchaser-investor for the purpose of enabling the purchaser-investor to start a business, and in which the seller represents (A) that the seller will provide locations or assist the purchaser-investor in finding locations for the use or operation of vending machines, racks, display cases or other similar devices, or currency-operated amusement machines or devices, or any other devices within the intent of sections 36b-60 to 36b-80, inclusive, as amended, as the commissioner shall by regulation or order determine, on premises neither owned nor leased by the purchaser-investor or seller; or (B) that the seller will purchase any or all products made, produced, fabricated, grown, bred or modified by the purchaser-investor using in whole or in part, the supplies, services or chattels sold to the purchaser-investor; or (C) that the seller guarantees, either conditionally or unconditionally, that the purchaser-investor will derive income from the business opportunity, or that the seller will refund all or part of the price paid for the business opportunity, or repurchase any of the products, equipment, supplies or chattels supplied by the seller, if the purchaser-investor is unsatisfied with the business opportunity; or (D) that the seller will provide a sales program or marketing program to the purchaser-investor, *provided sections 36b-60 to 36b-80, inclusive, as amended, shall not apply to the sale of a marketing program made in conjunction with the licensing of a registered trademark or service mark, provided (i) such trademark or service mark has been effectively registered under federal law; and (ii) for such trademark or service mark initially registered under federal law on or after October 1, 1996, the seller files with the commissioner a copy of the trademark or service mark certificate prior to any offer or sale in Connecticut, provided further that failure to file such certificate shall not, in and of itself, preclude reliance on this exclusion.* "Business opportunity" does not include the sale of an ongoing business where the owner of that business sells and intends to sell only that one business opportunity; nor does it include the not for profit sale of sales demonstration equipment, materials or samples, for a total price of five hundred dollars or less to any one person. *[Italics added.]*

California
§1812.201

"Seller assisted marketing plan" means any sale or lease or offer to sell or lease any product, equipment, supplies or services which requires a total initial payment exceeding five hundred dollars ($500), but requires an initial cash payment of less than fifty thousand dollars ($50,000), which will aid a purchaser or will be used by or on behalf of the purchaser in connection with or incidental to beginning, maintaining, or operating a business when the seller assisted marketing plan seller has advertised or in any other manner solicited the purchase or lease of the seller assisted marketing plan and done any of the following acts:

(1) Represented that the purchaser will earn, is likely to earn, or can earn an amount in excess of the initial payment paid by the purchaser for participation in the seller assisted marketing plan.

(2) Represented that there is a market for the product, equipment, supplies, or services, or any product marketed by the user of the product, equipment, supplies or services sold or leased or offered for sale or lease to the purchaser by the seller, or anything, be it tangible or intangible, made, produced, fabricated, grown, bred, modified, or developed by the purchaser using, in whole or in part, the product, supplies, equipment, or services which were sold or leased or offered for sale or lease to the purchaser by the seller assisted marketing plan seller.

(3) Represented that the seller will buy back or is likely to buy back any product made, produced, fabricated, grown or bred by the purchaser using, in whole or in part, the product, supplies, equipment or services which were initially sold or leased or offered for sale or lease to the purchaser by the seller assisted marketing plan seller.

BIOGRAPHY

Thomas M. Pitegoff
Pitegoff Law Office PLLC

445 Hamilton Avenue, Suite 1102
White Plains, NY 10601

Phone:	914-681-0100
Fax:	914-206-6003
Email:	pitegoff@pitlaw.com
Web :	www.pitlaw.com

Thomas M. Pitegoff helps companies grow their businesses by franchising. Aside from franchising, Mr. Pitegoff helps U.S. and non-U.S. companies establish business relationships that are not franchises. He also acts as general U.S. counsel for foreign companies and he provides outside general counsel services for U.S. companies that do not have in-house counsel.

Mr. Pitegoff is the sole member of Pitegoff Law Office PLLC. He is former Chair of the Franchise Committee of the New York State Bar Association's Business Law Section, a former member of the Governing Committee of the American Bar Association's Forum on Franchising, and a former editor of the *Franchise Law Journal*. He has the highest rating available from Martindale-Hubbell and from Avvo. He is listed among the best franchise lawyers worldwide in Who's Who Legal: The International Who's Who of Business Lawyers (London 2011) and was selected for inclusion in SuperLawyers 2011 as one of the top attorneys in the New York metro area in the field of franchising. He was also selected to the list of Franchise Times Legal Eagles 2011. He is a frequent writer and speaker on franchise law subjects.

Publications (partial list):

- *Franchising in New York After the Revised FTC Rule*, NYSBA Business Law Journal (2007).
- *Franchise Relationship Laws: A Minefield for Franchisors*, 45 BUS. LAW. 289 (1989), reprinted in the ABA's BUILDING FRANCHISE RELATIONSHIPS (1996) and FUNDAMENTALS OF FRANCHISING (3d ed. 2009)
- *Choice of Law in Franchise Relationships*, 14 FRANCHISE L. J. 89 (Spring 1995)
- *Ways to Avoid Being a Franchise*, FRANCHISE L.J. (Fall 1992)