

ACCIDENTAL FRANCHISES

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A franchise is a complex business arrangement governed by both federal and state law. It is a familiar concept to most people; however, the legal definition of franchising is very broad with a number of vague terms that are often frustrating. Both businesses and their legal representatives at times have difficulty in determining the application of these laws in specific situations. The application of the franchise laws are meant to protect all but the purchasers of a franchise and cannot be waived. Often times a business owner does not intend for its franchise, the so-called “accidental franchise.” In preparing this paper we extensively consulted and used the publications set forth in footnote 1 below.¹ Many publications on franchising are available from the ABA.²

Under the FTC Franchise Rule (the “FTC Rule” or “Rule”) a franchise is not determined by the business format, or whether the parties call their relationship a “franchise,” a “license,” a “distributorship” or a different name. Further, even if the parties to an agreement covenant that the relationship is not a franchise, it may still be a franchise and covered by the FTC Rule. Generally under the FTC Rule a franchise is determined by whether or not the following three elements are present in the transaction: 1) the “franchisee” receives a license for use of the licensor’s trademarks; 2) the franchisor exerts substantial control over or provides significant assistance to the “franchisee;” and 3) the franchisor charges a direct or indirect fee to the “franchisee” payable within a certain period of time.³ If these elements are all present, it is a franchise, no matter the business format or the designation of the relationship.

WHAT IS A FRANCHISE?

At its most basic level a franchise refers to a business relationship where one business, the “franchisor,” allows another business, the “franchisee,” the right to conduct a business offering certain designated products and services to others usually associated

¹In preparing this paper, we also extensively consulted the following publications: Traversing the Minefield: Recent Developments Relating to Accidental Franchises, by Paul R. Fransway, *Franchise Law Journal* Fall 2017, Volume 37, number 2; *The Laws of Franchising* authored by C. Jeffrey Thompson, Christian Thompson, et al., *Utah Business Law for Entrepreneurs and Managers*, 244-60 (David W. Read, et al., eds 2016).

²The beginning franchise attorney may find the ABA’s publication titled, *Fundamentals of Franchising* published by the Forum on Franchising, to be particularly helpful. This publication was consulted in preparing this paper *see* FUNDAMENTALS OF FRANCHISING (*Rupert M. Barkoff and Andrew C. Selden ed., 2008*).

³ 16 C.F.R. § 436 (1979). The FTC amended the Franchise Rule in 2007. 16 C.F.R. §§ 436, 436.1 (2007).

with a brand name or trademark for a fee. Franchising is also defined by statute in more than a dozen states, and by the Federal Trade Commission (“FTC”). Depending on whether the FTC Rule or state law is being referenced, these elements are often referred to as the: 1) “trademark,” element, 2) the “control or substantial assistance,” or “marketing plan,” or “community of interest,” element, and 3) the “fee” element. Each of these defined elements must be satisfied for the business arrangement to be considered a franchise.⁴

1. *Trademark License or Substantial Association*

The *trademark* element provides the franchisee with the right to use the trademark of the franchisor in the franchise business. This use includes such items as trademarks, certain proprietary methods such as, know how, recipes, etc. The trademark element has been subject to various interpretations. Under the FTC Rule, it is not just the licensing of the trademark to the franchisee that triggers the trademark element; rather, it is the association of the business with the trademark which creates a franchise relationship, and the express grant of the right to use the franchisor’s trademark is not required.⁵ Most courts examine the use of the trademark after the business relationship is formed with a commonly used four-part test: 1) percentage of sales or profits associated with the trademark; 2) the nature and extent of use; 3) how the public views the relationship; and 4) financial harm to the licensee if use of the discontinued trademark.⁶ If this element is to be avoided, the franchise or license agreement must specifically prohibit the franchise business from using the licensor’s trademarks. Some courts have found that the distribution of products or services covered by a franchisor’s trademark is sufficient to satisfy the substantial association requirement.⁷

2. *Substantial Control or Assistance, Marketing Plan, or Community of Interest*

a. Substantial Assistance or Control – FTC Rule

Under the FTC Rule, “substantial assistance” or “control” can be found where the franchisor exercises significant control over, or gives the franchisee significant

⁴ The FTC Rule defines a franchise as a “continuing commercial relationship created by any arrangement” where the following elements are included: (1) the franchisee sells goods or services that are substantially associated with the franchisor’s trademark, tradename or commercial symbol or must meet the franchisor’s quality standards, (2) the franchisor exercises significant control over, or gives the franchisee significant assistance in, the franchisee’s method of operation, and (3) the franchisee, as a condition of obtaining or commencing operations, is required to make payment, either directly or indirectly, aggregating more than \$500 within six months of commencing such operation. 16 C.F.R. §§ 436.2(a)(1)(i) and 436.2(a)(3)(iii).

⁵ See Thomas M. Pitegoff & W. Michael Garner, *Franchise Relationship Laws*, in FUNDAMENTALS OF FRANCHISING, 192 (Selden and Barkoff *ed.*, 2008).

⁶ See *Kinsley Grp. Inc. v. MWM Energy Systems* 2014 WL 4740577 (D. Conn, Sept 23, 2014).

⁷ *Master Abrasives Corp. v. Williams*, 469 NE 2d 1196 (Indiana APP 1984). *Wright-Moore Corp. v. Ricoh Corp.*, 908 F2d 128 (CA 1990).

assistance in, the franchisee's method of operation.⁸ The FTC Interpretive Guide sets forth that the more franchisees reasonably rely upon the franchisor's control or assistance, the more likely the control or assistance will be considered "significant." The following are indicative of control: approval of site location for unestablished businesses, design and appearance requirements, production controls, personnel policies, restrictions on customers or sales areas, required accounting practices, designation of hours of operation, and providing marketing or management advice,⁹ significant assistance to a franchisee under the FTC Rule will be found where the franchisor provides sales, repair, or business training; accounting systems; management, marketing, or personnel advice; assistance with site location; operating or training manuals; and system-wide marketing.¹⁰ Most product distribution programs include one or more of these elements. However, a franchisee's reliance is likely to be great when they are relatively inexperienced in the business being offered for sale, or when they undertake a large financial risk. Similarly, franchisees are likely to reasonably rely on the franchisor's control or assistance if the control or assistance is unique to that specific franchisor, as opposed to a typical practice employed by all businesses in the same industry.¹¹ The FTC has also provided specific actions by the supplier, relating to methods of operations, which will automatically trigger the element of "significant control or assistance."¹² The FTC has also given some direction of other actions which may or may not constitute "significant control or assistance" depending on the circumstances and some items that it will not consider when determining this element.¹³ For instance, the FTC has stated that "assistance with promotional activities is not enough to constitute 'significant' assistance or control and that for control to be considered significant, such control must be for the "entire method of operation."¹⁴ If the product

⁸ FTC Franchise Rule Compliance Guide, at 2 (2008) <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf>, (last visited August 5, 2015).

⁹ See *FTC Franchise Rule Compliance Guide*, *supra* note 5.

¹⁰ *FTC Franchise Rule Compliance Guide*, *supra* note 5.

¹¹ *Id.*

¹² Site approval for unestablished businesses; site design or appearance requirements; hours of operation; production techniques; accounting practices; personnel policies and practices; promotional campaigns requiring franchisee participation or financial contribution; restrictions on customers; location or sales area restrictions; formal sales, repair, or business training programs; establishing accounting systems; furnishing management, marketing, or personnel advice; selecting site locations; furnishing a detailed operations manual. Interpretive Guides to [1979] Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Federal Register 49966, August 24, 1979.

¹³ Trademark controls designed solely to protect the trademark owner's legal ownership rights in the mark; health or safety restrictions required by law or regulation; agreements between a retailer and a trading stamp company providing for the distribution of trading stamps in connection with retail sales of merchandise or service; agreements between a bank credit interchange organization and retailers or member banks for the provision of credit cards and credit services; and assisting distributors in obtaining financing to be able to transact business. FTC Franchise Rule Compliance Guide, at 4 (2008) <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf>, (last visited August 5, 2015).

¹⁴ Providing point-of-sale advertising displays, sales kits, product samples and other promotional materials intended to assist the distributor in making sales or assistance in media do not constitute "significant" under the FTC Rule. *Id.*

supplied will only be a small portion of the products to be sold by the distributor, then it would not rise to the level of “significant” required under the FTC definition.¹⁵

b. Marketing Plan or Community of Interest – In Certain States

1. Under a “marketing plan” element, a franchise exists if in addition to the trademark and fee requirements, the franchisor grants the right to engage in the business of offering, selling, or distributing goods or services under a marketing program or system prescribed in substantial part by the franchisor.¹⁶

a. The *marketing plan requirement* is often difficult to clearly define. Courts look for on-going substantial assistance or control, the sophistication of the assistance and direction from the franchisor, and shared economic interests in the business relationship.¹⁷

2. Under certain state laws, the marketing plan and community of interest elements (the correlatives of the FTC’s significant assistance element) are subject to varying definitions. Some sales find a marketing plan exists where advice or training is given regarding the operation of the business and the sale for the products or services being offered. California, one of the states using the marketing plan element, looks at such things as minimum purchase requirements, sales training, mandatory purchases, trade dress, and sales protocol.¹⁸ Most product distribution contracts will have some of these elements.¹⁹ In states that focus on a community of interest, that element is generally considered to have broader scope than a marketing plan because it is a continuing financial interest between the parties in the operation of the business or the resale of the products.²⁰ Therefore, this applies to almost any commercial contractual relationship, and a distributor must look to the regulations and courts to determine how a particular state defines this element in the community of interest states.²¹

¹⁵ *Id.*

¹⁶ *See Id.* at 189.

¹⁷ *See* Thomas M. Pitegoff & W. Michael Garner, *Franchise Relationship Laws*, in FUNDAMENTALS OF FRANCHISING, 189 (Selden and Barkoff *ed.*, 2008).

¹⁸ *See* California Division of Corporations, *Commissioner’s Release 3-F, When Does an Agreement Constitute a “Franchise”* (June 22, 1994), <http://www.dbo.ca.gov/Commissioner/Releases/3-F.asp> (last visited Aug. 4, 2017).

¹⁹ *See* Thomas M. Pitegoff & W. Michael Garner, *Franchise Relationship Laws*, in FUNDAMENTALS OF FRANCHISING, 189-190 (Selden and Barkoff *ed.*, 2008).

²⁰ *Id.* at 191.

²¹ Wisconsin lists 10 factors to consider in determining whether there is a community of interest: (1) Duration of the parties’ relationship; (2) extent and nature of the parties’ obligations; (3) the percentage of time or revenue devoted to the grantor’s products or services; (4) the percentage of the grantee’s gross proceeds or profits derived from the grantor’s products or services; (5) the extent and nature of the grantee’s territory; (6) the use of the grantor’s trademarks or logos; (7) the grantee’s financial investment in the inventory, facilities, and goodwill of the alleged dealership; (8) the personnel devoted to the alleged dealership; (9) the amount of money and time spent on advertising and promotions for the supplier’s products and services; and (10) the

3. *Payment of a Fee & Indirect Fees*

The *fee* element relates to separate consideration paid or promised by the franchisee business within a certain time period (usually six months) for the right to enter into the business relationship in combination with the other elements specified above.²² This fee may either be a direct payment to the franchisor or an affiliate or an indirect payment through the purchase of supplies or equipment at a price above marked value.²³

The franchise fee is not limited to payments made when entering into the contract. Under the FTC Rule payments include all consideration the franchise must pay either by contract or practical necessity. These can include payments for training, advertising, assistance, required equipment, supplies, deposits, promotional materials and videos, plus on-going royalties. The FTC Rule excludes payments made for merchandise held for resale at a bonafide wholesale price; hidden payments or fees will still be considered when determining if the contract constitutes a franchise. For example, requiring a franchisee to purchase a set amount of inventory to be purchased from the franchisor can constitute a fee.

In attempting to avoid being a franchise the easiest element to eliminate would appear to be the “fee element.” The supplier would not charge a fee to the distributor to sell the products; rather, the supplier would only sell the products for a bona fide wholesale price. This may or may not be possible under the particular business circumstances.

FEDERAL FRANCHISE DISCLOSURE REQUIREMENTS

If there is a franchise, the FTC Rule requires that a franchisor provide a prospective franchisee with a set of 23 disclosures prior to the purchase of a franchise. This disclosure document is referred to as the franchise disclosure document or “FDD.” The 23 disclosures or “items” in the FDD include among other things, information regarding the franchisor, its principals, the initial and ongoing fees the franchisee will have to pay, the initial investment required to commence business, initial and ongoing training, the franchisee’s territory, the number of outlets in the franchise system, etc. The franchisee must have these disclosures in hand for a minimum of 14 calendar days before the franchisee can sign an agreement or pay any money to the franchisor.

extent of supplemental services provided by the grantee to purchasers of the grantor’s products or services. *Ziegler Co., Inc. v. Rexnord, Inc.*, 407 NW2d 873 (ED Wis 1987).

²² 16 C.F.R. § 436.8(a)(i) see also Thomas M. Pitegoff & W. Michael Garner, *Franchise Relationship Laws*, in *FUNDAMENTALS OF FRANCHISING*, 193-194 (Selden and Barkoff ed., 2008).

²³ *See Id.*

The FTC does not require that the FDD be registered with the FTC. The FTC Rule only requires that the disclosures be made in compliance with the FTC Rule. The FTC Rule applies in all 50 states, Puerto Rico, Guam, the U.S. Virgin Islands, and other US territories and possessions.²⁴ Once the FDD has been properly prepared, the franchisor is free to sell franchises in those states that do not require a separate state filing. As further discussed below, the states that do not require any additional filings are considered “non-registration states” and the states that do require registration are considered “registration states.” However, a number of states with business opportunity laws like Utah, Texas and Florida still require some form of registration. If a franchisor wishes to sell a franchise in a registration state, the laws of that state must be followed. The additional state requirements must be followed because the relationship between the FTC Rule and state registration laws generally operate in such a way that the more protective of these laws will be enforced.²⁵ In other words, the FTC Rule generally will not preempt state laws where the state law requires more detailed or expansive disclosures.

Further, the FTC Rule specifically provides that it only applies to sales of franchises that are to be located or operated in the United States or its territories and commonwealths, and not whether the prospective franchisee is a U.S. resident or U.S citizen.²⁶ However, in some states, the law on this issue is unclear, so the statutory provisions must be carefully reviewed if the offer or sale of a franchise to be operated out of the U.S. is made to a resident of a registration state.

2. State Registration of the Franchise Disclosure Document

Fifteen states have laws and regulations that govern some aspect of selling franchises. Most of these states require that a franchisor register with the state and provide certain disclosures prior to selling franchises in their state. Those states are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.²⁷

²⁴ See also Rochelle B. Spandorf and Mark B. Forseth, *Franchise Registration* in FUNDAMENTALS OF FRANCHISING, 132 (Selden and Barkoff ed., 2008).

²⁵ *Id.*

²⁶ *Id.* at 135.

²⁷ *Id.*