FRANCHISING LAW AND PRACTICE: THE US EXPERIENCE
(Expanded Outline)

I. Introduction

From a commercial viewpoint, one of the most important, and from a legal standpoint, one of the most difficult and intricate forms of intellectual property (IP) licensing is franchising.

As regards the former, franchising is big business. It has seen phenomenal growth in recent times. Already in the early '90's franchised business accounted for over

— $700 billion in annual sales
— 30% of the Gross National Product
— 38% of all retail sales
— 500,000 locations across the country
— 6 million people employed.

Thus, franchising has been a major segment of the economy, and by the year 2000 will attract half of all consumer spending. It is also very popular and versatile form of marketing as well as expanding businesses internationally.

With respect to the legal perspective, franchising in the US is heavily regulated. Federal law imposes substantial disclosure requirements and a number of states have their own additional disclosure and/or registration or notification requirements and may also impose substantive regulations over the content of the agreements. Failure to comply with all appliable federal or state franchise laws can subject the violator to injunctions and substantial civil fines and may result in the rescission of the agreement.

There is a danger that an IP agreement, especially a trademark license, and even a technology license or a distributorship agreement, may inadvertently or accidentally create a franchise and fail to comply with the federal and state franchise laws and regulations. Thus, it is a serious pitfall or trap for the unwary that such licenses or agreements may easily constitute "franchises." In other words, a party to a licensing or distribution agreement may be a franchisor and not know it and find itself facing dire consequences.

Coverage under franchise laws cannot be avoided simply by describing a relationship as a "license" or by some other name, or by drafting contracts that do not literally reflect the characteristics of a franchise.

II. Types and Definitions of Franchises

A. Economic/Practical Types

In business terms, a franchise is a form of distribution systems, a method of marketing, under which the franchisor grants — in return for a fee — a franchisee the right to market and distribute certain goods and/or services under established trademarks or service marks, in accordance with specified standards, in an agreed-upon relationship.

A trademark license is usually the core of a franchise relationship. The license to use the trademark is the vehicle for the franchisee to become part of the business system with uniform format and quality standards.

While there are many different forms and kinds, franchises may be divided into four basic types:

(1) A distribution franchise — one in which the primary purpose is for the franchisee to serve as an outlet for products manufactured by or for the franchisor. Examples are franchised sales outlets for bicycles, automobiles, and gasoline.

(2) A manufacturing franchise — one in which the franchisor permits franchisees to make and sell products using either raw materials and/or specifications supplied by the franchisor. Examples are mattress and bedding manufacturing and the local bottling and canning of soft drinks.

(3) A "business format" — one in which the franchisor is primarily licensing a business format or system, rather than selling goods identified with the franchisor. In this type of franchise, the franchisee is primarily paying for the use of a franchisor's well-known and advertised mark together with training, operating specifications, and business know-how supplied by the franchisor.

(4) An affiliation franchise — one in which the franchisor recruits into its system as franchisees persons who are already established in the particular line of business. Each of the businesses is required to adopt and use the franchisor's mark, but they may be permitted to continue using their own marks a secondary marks. These businesses rarely use the same overall presentation or identity format except for the mark itself. Examples are insurance, financial, and real estate brokerage services.

B. Legal Definitions of Franchises

1. Federal Trade Commission (FTC) Rule

The FTC Rule is applicable to all relationships which meet the statutory definition of a franchise, whether or not the parties intend to create a franchise and use the term "franchise" to characterize the relationship. The term "franchise" according to the FTC Rule encompasses any relationship in which:

(1) The franchisee sells goods or services associated with the franchisor's trademark or service mark. This element is satisfied if the franchisee has the right to sell or distribute goods associated with the franchisor's trademark, with or without a formal licensing agreement.

(2) The franchisor has the power to exert significant control over, or promises significant assistance with, the franchised business. Any of the following factors bespeaks the existence of significant control or assistance:

(a) offering formal sales, repair or business training programs,
(b) establishing accounting systems,
(c) furnishing management, marketing or personnel advice,
(d) selecting site locations, or

(e) furnishing a detailed operating manual.

Whether the licensee has become dependent upon the licensor's control or assistance, is the test, rather than trademark quality control.

(3) The franchisee is required to pay the franchisor over $500 during the first six months of the agreement. Any "required payment" from the franchisee to the franchisor which:

(a) is over $500,
(b) is a condition of maintaining or commencing the franchise operation, and
(c) must be made before or within the first six months after commencing operation, will satisfy the fee element.

"Required payment" can include rent, advertising assistance, required equipment and supplies, training, security deposits, escrow deposits, bookkeeping, promotional literature, equipment rental, and continuing royalties on sales.

2. State Definitions

The states vary widely in their definition of "franchise." Most state statutes governing franchises define a franchise relationship as one in which the franchisor provides goods or services for the franchisee to sell, the franchisee operates under the franchisor's trademark or other commercial symbol, and the franchisee pays some sort of fee.

Some states vary from this norm, though. For example, New York does not require use of a franchisor's trademark in order to qualify the relationship as a franchise, if the franchisee pays the franchisor a fee and submits to the franchisor's requirements in marketing and operations.

Many states define categories of "business opportunities" and "business investments" that are subject to regulation designed to protect franchisees. The business elements of the relationship may bring an arrangement within the rubric of these state statutes, even though they are not called "franchises."

3. Exceptions and Exemptions

The franchise laws provide for several exceptions, exclusions and exemptions, so that in some cases relationships can be structured to avoid these stringent requirements, as follows:

(a) "Fractional franchises — where a business that has been in existence for more than two years enters into a franchise relationship, and the parties anticipate that the new franchise relationship will not increase sales by more than 20% of the dollar volume of the pre-relationship sales.

(b) Oral agreements — where there is no writing evidencing any material terms of the relationship.

(c) Single trademark licenses — where a trademark licensor offers only one trademark license agreement of a particular type with respect to one trademark.

(d) Experienced franchise relationships — many state franchise laws

exempt large and experienced franchisors, sophisticated franchisees, agreements between franchisors and franchisees who already have a franchise relationship.

(e) Categories of industries — certain industries or categories of business arrangements are exempt from state franchise laws because of public policy considerations, or because these industries or business arrangements are already regulated by other legislation, such as motor vehicle dealers, bank credit plans, sellers of farm machinery, and marketers of petroleum products.

(f) Size and net worth — like the federal government, many states seek to exclude business arrangements initiated by franchisors whose net worth exceeds a specific amount, or who have specified years of experience administering franchise systems of a specified size.

III. Business Advantages of Franchising

A. Franchisor's Benefits

(a) The franchisor can engage in rapid system expansion and market penetration without the expenditure of any capital whatsoever, but instead with an infusion of capital.

(b) The franchisor acquires the aggressive self-motivation of franchisees, whose ownership fervor is generally far greater than that of employee managers.

(c) The franchisor can rely on "local entrepreneurs" that can decipher local requirements because of their direct customer contact and garner goodwill engendered in that contact.

(d) The franchisor can obtain revenue from a variety of sources: a substantial fee for the sale of the franchise, a royalty for the use of the mark and the business system, savings due to reduction of large inventories and profits due to economies of scale in the production, storage, and handling of products.

(e) The franchisor has the ability to motivate and control huge numbers of indirect employees, avoids a certain amount of risk inherent in most businesses, receives the benefit of the constant accretion to the value of its trademark or service mark.

B. Franchisee's Benefits

(a) The franchisee is given access to a proven product or service that has been advertised and is known to customers.

(b) The franchisee benefits by the guidance provided by the franchisor in the form of business standards and from a standardized management system and methods of internal control.

(c) The franchisee is assisted in capital matters like site selection, design and engineering of the facility, layout, choice and sources for equipment, furnishings, supplies and even general contractor services.

IV. Franchise System Structure

A prospective franchisee has little choice but to put his entire faith and confidence in the franchisor. From sources of supply to advertising, to orders, payments, credits, discounts, the franchisee must look to the franchisor for total guidance in every material aspect of the franchise relationship.

As franchising is a creature of contract, the entire structure of a franchise system will be contained in a franchise agreement or series of franchise agreements, which set forth in detail the rights, duties, obligations and activities which each party pledges to undertake and perform. The basic franchise is the unit franchise relationship, in which a franchisee is given the right to open and operate one — and only one — franchise outlet, usually at a specified location and within a designated territory.

The beginning point of the franchise relationship is the duration of the franchise relationship. This is not an easy question. If the term if too short, it will attract few buyers. Franchisees are purchasing a business opportunity where time is needed to develop name recognition, to maximize goodwill and to recoup their investment. If the term of the franchise is too long, the franchisor may be stuck with a less than desirable franchisee, who is unwilling or unable to operate the franchise successfully.

Another key feature of the franchise structure is the grant of territorial rights. It is most common for franchisors to confer upon franchisees some degree of territorial protection for their businesses, so-called "exclusive territory". Selection of the franchise location and the construction of the franchise unit are also important. Franchisor approval of any franchisee-selected site should always be provided for. Further, any relocation rights should be addressed as well.

Two types of franchise relationships of interest are the individual or unit franchises and area franchises. Individual or unit franchises are those in which a franchisee is granted the right to develop and operate one outlet at a specific location or with a defined territory. Unit franchises may also be offered as an incentive for growth for existing franchise owners, with additional franchises granted to successful franchisees.

Area franchises are those with multiple outlet franchises or area development agreements and may include subfranchisors and master franchisors. Under these arrangements, a franchisee may be granted the right to develop and operate two or more outlets within a defined territory or, in some instances, the right to subfranchise some of these development responsibilities. In area franchises, a single development agreement is used to grant development rights for all outlets to be developed by the franchisee. Separate franchise agreements are then used to grant specific rights related to each outlet.

V. Disclosure and Registration Requirements

Federal and state regulations now protect prospective franchisees by requiring disclosure and registration by franchisors.

A. The FTC Rule imposes six different requirements in connection with the "advertising, offering, licensing, contracting, sale or other promotion" of a franchise in or affecting commerce."

1. Basic Disclosures

Franchisors must give potential inventors a basic disclosure document at the earlier of the first face-to-face meeting or ten business days before any money is paid or an agreement is signed in connection with the investment.

2. Advertised Claims

Only advertisements that include an earnings claim are affected. Such ads must disclose the number and percentage of existing franchisees who have achieved the claimed results, along with cautionary language. Their use triggers required compliance with the Rule's earnings claim disclosure requirements.

3. Earnings Claims

If franchisors make earnings claims, whether for past or future, they must have a reasonable basis, and prescribed substantiating disclosures must be given to potential investors in writing at the same time as the basic disclosures.

4. Franchise Agreements

Franchisors must give investors a copy of their standard-form franchise and related agreements at the same time as the basic disclosures, and final copies intended to be executed at least five business days before signing.

5. Refunds

Franchisors must make refunds of deposits and initial payments to potential investors, subject to any conditions on refundability stated in the disclosure statement.

6. Contradictory Claims

While franchisors are free to provide investors with any promotional or other materials they wish, no written or oral claims may contradict information provided in a requirement disclosure.

B. Failure to comply with any of the six requirements is a violation of the FTC rule and the FTC can impose civil penalties of up to $10,000 per violation. They can also require rescission, reformation, payment of refunds or damages, or combinations of these remedies, and they can issue cease-and-desist orders. There is no private right of action for violations of the FTC Rule. Remedies do, however, exist under state law. State franchise and business opportunity laws, and state consumer fraud or "little FTC acts," which typically cover the sale of franchises and frequently make any violation of the FTC Rule a state law violation, generally provide a private right of action for rescission, damages, costs and attorneys' fees, and sometimes multiple or punitive damages. Willful violations of state laws may also result in criminal penalties, including fines and imprisonment.

C. Because disclosures required by state registration and disclosure laws can be used to satisfy the requirements of the FTC Rule, state disclosure laws should be kept in mind. Sixteen states require franchisors to register and disseminate to prospective franchisees a prospectus-type disclosure document prior to engaging in any franchise sales activity. Unless a statutory exemption is available, no offer or sale of a franchise can take place unless and until the franchisor has filed with the appropriate state agency — and that agency has approved and registered — a prospectus setting forth honestly and in detail all of the material facts of the franchise sales transaction. This registered prospectus must then be given to prospective franchisees at the earlier of:

(a) the "first personal meeting" between a franchisor and its prospective franchisee (i.e. the first face-to-face meeting held for the purpose of discussing the sale, or possible sale, of a franchise);

(b) ten business days prior to the execution by the prospective franchisee of any franchise-related agreement; or,

(c) ten business days prior to the payment by the prospective franchisee of any monies or other consideration in connection with the sale, or proposed sale, of a franchise.

D. Sixteen states, Puerto Rico and the District of Columbia have adopted franchise relationship laws with different definitions of the term "franchise," but with most definitions having a combination of the following elements" (a) either a marketing plan or community of interest element' (b) a trademark element; and (c) a fee element.

1. Marketing Plan

Generally, a marketing plan exists whenever the franchisor presents the group of franchised outlets to the public as a unit, with the appearance of some centralized management and uniform standards.

2. Community of Interest

Some of the franchise laws require that a franchisor and franchisee maintain a "community of interest" in the marketing of the goods or services. This is usually a much broader element than the marketing plan. A community of interest exists for example, where the parties have a continuing financial interest and a degree of interdependence. This can refer to almost any ongoing business relationship in which the dealer has an investment in the business.

3. Trademark

The trademark element of the state relationship laws will always be satisfied if the franchisee is licensed to do business under the franchisor's name or mark. Most of the marketing plan franchise laws, however, do not require a license. In some states, the operation of the franchisee's business must be "substantially associated" with the franchisor's trademark. In other states, the trademark element is satisfied where the franchisor's trademark identifies the goods or services sold, rather than the business itself, which would include many ordinary distributorships.

4. Fee

The fee element of the definition of a franchise generally means any fee or charge that the franchisee is required to pay for the right to do business under the franchise agreement. This payment does not have to be in the form of a franchise fee; it may also be royalties on sales. As a result, almost any trademark license agreement would satisfy this requirement.

VI. Horror Stories

A. The "Kis" of Death

An example of how franchise laws may be bootstrapped onto — and lead to the demise of — a business entity nominally unconcerned with franchising can be found in *Matter of the KIS Corp.* and its progeny. KIS was a French manufacturer of one-hour photographic minilabs which it offered and sold in the US. Under the KIS program, purchasers of minilab equipment were entitled to display a "KIS" banner in their windows and were further given (for free) marketing advice that purchasers could follow or ignore, as they wished. KIS was warned by counsel that, although it was not a franchise in any sense of the word, it was so close that prudence dictated that it act as a franchisor (and register and disseminate disclosure documents accordingly), even though it was not.

KIS rejected this advice and, within a two-year period, found itself the subject of no fewer than five state investigations and one FTC investigation alleging it to be a franchisor that had failed to comply with federal and state franchise registration and disclosure laws.

KIS spent hundreds of thousands of dollars defending itself in these investigations (and in related private lawsuits charging that it was a franchisor) and, ultimately, ceased all business activities in the US — but not before the FTC made it enter into a consent agreement coupled with a penalty of more than $1 million.

Then an extraordinary event transpired in Wisconsin, one of the states that was investigating KIS. At the conclusion of its investigation, the state entered a stop order under its franchise statute, prohibiting KIS from any further sales activity. The order was lifted by a court upon KIS's motion. Thereafter, in an administrative proceeding, KIS argued that the Wisconsin Commissioner of securities exceeded his authority in construing the term "prescribed marketing plan or system" (one of the definitional elements of a franchise under Wisconsin's franchise law) as embracing mere suggestions that could have been ignored by the KIS minilab purchaser.

The administrative judge agreed and held that the Commissioner acted in an *ultra vires* fashion in promulgating a regulation to the effect that mere "assistance" constituted a prescribed marketing plan or system. The administrative judge held that to find a marketing plan or system present, the putative franchisor's "suggestions" had to be backed up either with some type of sanction for noncompliance or with a showing that, in fact, the "optional" assistance was not optional at all, in that the purchaser did not have unrestricted autonomy in the operation of its business.

The KIS administrative judge struck down those portions of the Wisconsin Administrative Code that held that mere suggestions sufficed to conclude that a "prescribed marketing plan or system," and thus a franchise, existed. This case is especially important given the fact that Wisconsin's definition of the term franchise is substantially identical to the majority of other regulating states' definitions.

B. Other Painful Lessons

The same warning applies not only to manufacturers, but to other nontraditional franchisors.

For example, in New York, radio dispatched black car limousine services, so heavily used by New York City's law firms, have been deemed to be franchisors (as per *Aristacar* decision). Their drivers pay a fee for the opportunity of participating in the radio dispatch service (fee element), their drivers are required to conduct business under the car service service mark (trademark element), and the company typically regulates virtually every aspect of its drivers' activities, including the type of car to be driven, dress code and how customers should be treated (marketing plan element).

Even distribution agreements can bring massive headaches to equipment manufacturers. For in the recent case of *Cooper Distributing v. Amana Refrigeration,* the US Court of Appeals for the Third Circuit construed the definition of the term "franchise" under the New Jersey Franchise Practices Act (which enjoins franchise terminations absent good cause) as including a relationship between a manufacturer and distributor where a community of interest in the sale of the underlying product existed. Of critical importance is the fact that the court so held even though the distributor (i.e., the "franchisee") at issue conducted business under its own name, and not under the manufacturer's name, Amana.

In another case stretching the definition of a "franchise" to cover a distributorship, a snack distributor was found to be a franchise under the Minnesota Franchise Act because the distribution agreement authorized the distributor to use the "All Snax" trademark, even though the distributor did not actually use the trademark. While the distributorship seller denied that there was a community of interest because the distributor purchased goods directly from snack

manufacturers and paid the distributorship seller no royalty or percentage of sales, the distributor received a financial benefit from the manufacturers depending upon the amount of products the distributor ordered. The court found this was sufficient community of interest, even though distributorship seller exercised no control over the distributor and the distributor made no specific investment for the "franchise."

The grave danger and how far the courts will go to deem an ordinary license to be a franchise, is also highlighted by a recent California court ruling that distributors of a proprietary business recordkeeping system were franchisees under the California Franchise Investment Law, even though they did not actually sell any products or services (they just processed orders), could not enter into binding contracts with customers and bore no risk of loss because they never took title to the products ordered through them.

VII. Conclusion

Before the modern franchising system developed, the courts tended to apply traditional principles of contract law to franchise contract issues, real property law to real property issues, and the like, without recognizing the unique character of the franchisor-franchisee relationship. However, as the franchising concept began to expand rapidly through the economy over the last three decades, so too did the case law. The number of judicial decisions directly involving business format or chain-style franchising problems increased annually. Today, there is a recognized distinct body of law specifically dealing with the major concerns of the franchising industry and the franchising parties.

But franchising law and practice are not static. It's a fertile field for legislation and litigation. Developments and trends abound. Particularly noteworthy is that a new Uniform Franchise and Business Opportunities Act and a Model Law for Franchising are in the works, with the former having seen, or soon to see, the light of day. This is a most salutary development in light of 1) great differences in existing laws and regulations among the states and on the federal level with respect to definitions and other aspects, 2) many unresolved issues regarding duty of good faith, earnings claims, liability for due diligence, etc. 3) development of new forms of franchising, such as, niche franchising, and 4) significant economic changes, with the market place demanding greater levels of franchisor experience and financial strength.

Karl F. Jorda
David Rines Professor of Intellectual Property Law
Franklin Pierce Law Center, Concord, NH
10.28.99