

The Colorado Lawyer

The Official Publication of the Colorado Bar Association

January 2016 | Vol. 45, No. 1 | Page 25

Articles-Business Law

Hidden Franchises

by Craig J. Knobbe

Business Law articles are sponsored by the CBA Business Law Section to apprise members of current substantive law. Articles focus on business law topics for the Colorado practitioner, including antitrust, bankruptcy, business entities, commercial law, corporate counsel, financial institutions, franchising, and securities law.

Coordinating Editors

David P. Steigerwald of Sparks Willson Borges Brandt & Johnson, P.C., Colorado Springs—(719) 475-0097, dpsteig@sparkswillson.com; Curt Todd, Denver (bankruptcy)—(303) 955-1184, ctodd@templelaw.comcastbiz.net



About the Author

Craig J. Knobbe is a partner at Moye White LLP. He represents franchisors regarding franchise registration and disclosure laws, corporate matters, mergers and acquisitions, general business issues, and real estate matters.

Attorneys address a variety of important issues when forming new business relationships or counseling clients on existing commercial arrangements. This article illustrates how a commercial arrangement, such as a license agreement, joint venture, or consulting agreement, could be a "franchise" subject to regulation under the complex network of federal and state franchise laws.

Ongoing business relationships can be created through a variety of arrangements, including license agreements, distributorships, joint ventures, and consulting agreements. Under these arrangements, legal and business questions must be addressed at the outset by the attorney and client to ensure the relationship complies with applicable law and to increase the probability that the business relationship will be successful and profitable. Although an attorney will tackle many legal questions when the relationship is formed, it is entirely possible that even an experienced practitioner will fail to recognize that the business relationship being created, whether a joint venture, consulting agreement, or licensing agreement, is actually a "franchise" subject to regulation under federal and state law. This issue can be missed or overlooked due to the confusing and far-reaching network of federal and state franchise laws. In fact, it is irrelevant that the parties do not call the business relationship a franchise¹ and never intended to create a franchise relationship. If the business relationship satisfies the elements of the federal or state definition of a franchise, it is a franchise and subject to regulation.

Regulation of Franchise Relationships

Franchise relationships are regulated through a complex combination of federal and state laws. The following is an introduction to the federal and state regulations that govern franchise relationships.

Federal Franchise Regulation

In July 2007, the Federal Trade Commission (FTC) adopted the "Disclosure Requirements and Prohibitions Concerning Franchising" (FTC Franchise Rule) to amend the original franchise disclosure

rule that was promulgated in 1978 to regulate the franchise sales process.² The purpose of the FTC Franchise Rule is to regulate the pre-sale process by requiring the franchisor to make disclosures to the prospective franchisee. The idea is that these disclosures will allow the prospective franchisee to make an informed investment decision. Under the FTC Franchise Rule, the franchisor must provide the prospective franchisee with certain material information about the franchisor and the franchise opportunity in the form of a franchise disclosure document (FDD) before a sale is closed.³ The form and content of the FDD is described in the FTC Franchise Rule and, if applicable, state franchise laws. All proposed agreements between the parties, including the franchise agreement, lease, and purchase agreement,⁴ must be included as part of the FDD, but the FTC does not regulate the continuing relationship of the parties. The FTC Franchise Rule does not require the franchisor to register or file the FDD with the FTC.

State Franchise Sales Regulations

The FTC Franchise Rule does not preempt state franchise laws, except to the extent a state's franchise laws fail to provide equal or greater protection than the FTC Franchise Rule.⁵ As such, the FTC Franchise Rule sets a minimum federal standard for franchise disclosures, and states are allowed to provide greater protection and require more extensive disclosures if desired. Currently, 15 states⁶ regulate franchise sales through franchise registration and/or disclosure laws. In 14 of these states (often referred to as "Registration States"⁷), a franchisor must register its offering with the appropriate state regulatory authority, or obtain an exemption from registration, prior to the offer or sale of franchises in the state. Colorado is not among the Registration States, meaning that the FTC Franchise Rule is the regulation that would apply to a business relationship formed in Colorado. But caution is advised, as the broad jurisdictional scope of certain state franchise laws could result in the application of a state's franchise laws to a transaction in another state that does not have its own franchise laws. For example, Maryland's franchise laws could apply to a transaction in a state that does not regulate franchises if one of the parties is a Maryland resident.⁸

Applicability

As discussed in detail below, determining whether the state and federal franchise laws apply to a business relationship depends on whether the elements of the "franchise" definition are satisfied. The FTC Franchise Rule and the state franchise disclosure and registration laws include franchise definitions. Additionally, many states have "relationship laws" that regulate certain substantive terms of the franchise relationship, such as termination, nonrenewal, and assignment. Although relationship laws do not address pre-sale disclosure or registration, certain state relationship laws include a franchise definition.⁹ This is important because a party in a private action could refer to the definition in the state's relationship law to support the argument that a business relationship is a franchise. Colorado does not have a relationship law, and a relationship law does not currently exist at the federal level. As such, this article does not include an in-depth discussion of the state franchise relationship laws.

Business Opportunity Laws

Until 2007, the FTC regulated the sale of business opportunities, along with franchises, under the original version of the FTC Franchise Rule. However, in July 2007, the FTC's amendments to the original FTC Franchise Rule included the creation of a separate regulation applicable to the sale of business opportunities called the "Disclosure Requirements and Prohibitions Concerning Business Opportunities" (FTC Business Opportunity Rule).¹⁰ The FTC Business Opportunity Rule is similar to the regulation of business opportunities under the original FTC Franchise Rule and was finally adopted by the FTC in December 2011. In addition to the federal business opportunity regulation, 26 states¹¹ have business opportunity laws and two additional states¹² and the District of Columbia have consumer protection laws that cover business opportunities—Colorado is not among these states. The business opportunity laws are relevant in various states because the definition of a "business opportunity" sometimes includes traditional franchises. An in-depth discussion of the federal and state business opportunity regulations is beyond the scope of this article. But suffice to say that under many state business opportunity laws, a franchisor is exempt from the business opportunity registration process if it complies with the federal franchise laws.¹³ In other states, a franchise program is exempt from the business opportunity laws if the program includes a "federally registered trademark" or a "registered trademark."¹⁴

Definition of a "Franchise" Under Federal Law

The FTC Franchise Rule defines a "franchise" as:

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.¹⁵

A business relationship is within the scope of regulation under the FTC Franchise Rule if each of the three elements of the franchise definition are satisfied. However, a business relationship that satisfies all three definitional elements may not be regulated under the FTC Franchise Rule if the relationship satisfies an exemption or exclusion specifically described in the FTC Franchise Rule.

> **Trademark element.** The trademark element of the franchise definition is intended to be read broadly.¹⁶ This element is often satisfied when the goods or services the franchisee distributes are associated with the franchisor's mark or when the franchisee must conform to the franchisor's quality standards for the goods or services it distributes.¹⁷ Illustrating the broad manner in which the trademark element is interpreted, an FTC informal staff advisory opinion explained that it would be inappropriate to find that the trademark element of the definition was not met when the written agreement between the parties was silent as to whether the buyer had authority to use the seller's marks.¹⁸ In this opinion, it was determined that the issue of whether the buyer was given implied or apparent authority to use the seller's trademark was not addressed because the written agreement was silent on this issue.¹⁹ The opinion recommended that the seller specifically prohibit the buyer's use of the seller's marks in the contract to minimize the risk of inadvertent coverage under the FTC Franchise Rule.²⁰

> **Significant control or assistance element.** A business relationship is not regulated under the FTC Franchise Rule unless the franchisor also exercises "significant control" over or provides "significant assistance" to the franchisee in its method of operation. Determining whether the assistance or control in the relationship is significant is highly dependent on the facts and requires an analysis of the provisions of the contract and the policies of the franchisor. For instance, if a franchisee's dependence on the franchisor's expertise is high, there is a greater likelihood that the control or assistance from the franchisor is significant.²¹ In circumstances where a franchisee is inexperienced or taking a large financial risk, the franchisee's dependence on the franchisor's experience is probably high.²² The FTC also explains that to be deemed significant, the control or assistance must be related to the franchisee's entire method of operation, not just a small part of the franchisee's business, such as assistance or control related to the sale of a product that has a minimum effect on the franchisee's method of operating the business.²³ According to the FTC, significant types of control include the following:

- site approval for unestablished businesses
- site design or appearance requirements
- hours of operation
- production techniques
- accounting policies
- personnel policies
- promotional campaigns requiring franchisee participation or financial contribution
- restrictions on customers
- locale or area of operation.²⁴

Significant types of assistance include:

- formal sales, repair, or business training programs
- establishing accounting systems
- furnishing management, marketing, or personnel advice
- selecting site locations
- furnishing system-wide networks and website
- furnishing a detailed operations manual.²⁵

The FTC also explained that promotional activities, without additional forms of assistance, are not significant.²⁶ For example, providing advertising and marketing materials to help make sales without providing additional forms of assistance does not satisfy this element of the franchise definition.²⁷ Additionally, the FTC confirmed that as a matter of policy, the following items do not satisfy the significant control or assistance element of the definition: trademark controls designed solely to protect the trademark owner's legal ownership rights in the mark under state or federal trademark laws; health or safety restrictions required by federal or state law or regulations; agreements between a bank credit interchange organization and retailers or member banks for the provision of credit cards or credit services; and assisting distributors in obtaining financing to be able to transact business.²⁸

> Required payment element. The FTC Franchise Rule defines "required payment" as "all consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise. A required payment does not include payments for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale or lease."²⁹

The FTC is clear that "payment" should be read broadly to capture all sources of revenue the franchisee must pay the franchisor or its affiliate for the right to associate with the franchisor, market its goods or services, and commence operation of the business.³⁰ Examples of required payments include the following: initial franchise fee; rent; advertising assistance; equipment and supplies (including purchases from third parties if the franchisor or its affiliate receives payment as a result of the purchase); training; security deposits; escrow deposits; nonrefundable bookkeeping charges; promotional literature; equipment rental; and continuing royalties on sales.³¹ The "practical necessity" language in the required payment element of the definition further supports a broad reading of the term "payment." In situations where a payment is not required by contract, a payment can still fulfill the fee element of the definition if the payment is required by "practical necessity." The situation where equipment can only be purchased from the franchisor or its affiliate (and no other source) is an example of a payment required by practical necessity.³²

According to the definition, a required payment does not include payment to purchase "reasonable amounts" of inventory for resale or lease at bona fide wholesale prices.³³ Reasonable amounts of inventory are defined as "amounts not in excess of those that a reasonable businessperson normally would purchase for a starting inventory or supply, or to maintain an ongoing inventory or supply."³⁴ The FTC further notes that the "inventory payment exception" does not include goods that must be purchased by a franchisee for its own use to operate the business, such as equipment and ordinary business supplies.³⁵

Another payment that is not considered a required payment is a payment to an unaffiliated third party for ordinary business expenses, provided that such third party does not pass the payment on to the franchisor or one of its affiliates.³⁶ The FTC took this position in the Interpretive Guides³⁷ and in the Statement of Basis and Purpose for the FTC Franchise Rule.³⁸ However, the Interpretive Guides explain that an ordinary business payment for equipment rentals and real estate leases could be a "required payment" if the payment is not made to an unaffiliated third party, or is made to benefit the franchisor.³⁹

Exemptions

If a business relationship satisfies the definition of a franchise under the FTC Franchise Rule, the relationship may not be subject to the regulations of the rule if one of the following exemptions applies.

> Sophisticated investors and insiders. The FTC Franchise Rule contains three "sophisticated investor" exemptions that exempt certain relationships from coverage of the FTC Franchise Rule.⁴⁰ The first exemption relates to the amount of the investment, the second relates to an investor's net worth, and the third relates to the investor's involvement with the company. Similar exemptions exist under certain state franchise laws.⁴¹ If the availability of an exemption under state law is narrower than a similar exemption under the FTC Franchise Rule, the additional conditions under that state's law must be satisfied to qualify for the exemption in that state. In states that do not regulate the offer and sale of franchises, only the federal requirements must be met to qualify for the exemption. It should be noted that all three of the sophisticated investor exemptions were added as part of the 2007 amendment to the FTC Franchise Rule, and the FTC has provided limited guidance regarding their application.

1. Large investment exemption. The basis for the large investment exemption is the FTC's belief that one sign of sophistication is the level of investment made by a prospective franchisee.⁴² The theory is that an individual capable of making a large investment will demand and obtain from the seller the information which is important to make a decision regarding the investment.⁴³ To qualify for this exemption, the following two requirements must be satisfied:

- The franchisee's initial investment is at least \$1,084,900.⁴⁴ Excluded from the \$1,084,900 is: (1) any financing received from the franchisor or an affiliate of the franchisor; and (2) the cost of unimproved land. Although funds received from the franchisor or an affiliate of the franchisor are excluded from the \$1,084,900 threshold, other financed amounts will count toward the \$1,084,900 threshold.
- The prospective franchisee must sign an acknowledgment that verifies the grounds for the exemption.⁴⁵

The large investment exemption only applies if at least one individual in an investor group qualifies for the exemption by investing at the threshold level of \$1,084,900 (taking the exclusions into

account).⁴⁶ The term "individual" means the investment of a single person. For example, if the prospective franchisee is an entity, at least one of the individual owners that is not an entity must satisfy the \$1,084,900 minimum investment requirement. In addition, the \$1,084,900 threshold relates to the initial investment of the individual and not ongoing business expenses. The term "initial investment" means the amount required to be invested by the individual to cover: (1) the expenses incurred during the start-up phase of the business (to get the business operational); and (2) the working capital needed during the three months following the date the business opens.⁴⁷

2. Large franchisee exemption. The basis for the large franchisee exemption is that a wealthy, experienced investor can obtain the benefits that are otherwise provided by the FTC Franchise Rule.⁴⁸ In other words, these investors can adequately protect themselves when negotiating a purchase of a franchise. To qualify for this exemption, the franchisee (or its parent and any affiliates) must be an entity (or an individual) that (1) has been in business for at least five years, and (2) has a net worth of at least \$5,424,500.⁴⁹ The business experience required under this exemption can be in any line of business and does not need to be in the area of the franchised business or in franchising.⁵⁰ The business experience of the franchisee's parent or affiliate companies may be considered when determining whether the franchisee is a large franchisee.⁵¹ It is also acceptable to aggregate the commonly owned assets of the franchisee (or its parent and any affiliates) to determine whether the net worth threshold is met.⁵² According to the FTC's Compliance Guide, net worth can be readily determined by reviewing an entity's balance sheet or other financial information.⁵³

3. Insider exemption. The reasoning behind the insider exemption is that an officer, director, owner, or employee with certain management responsibilities is familiar with most, if not all, aspects of the business it is employed by or owns.⁵⁴ As such, this individual is well positioned to understand and evaluate the risks associated with the business. To qualify for this exemption, an investor must purchase at least a 50% ownership interest in the franchise and one of the two following requirements must be satisfied:

- The investor is/was an officer, director, general partner, or individual with management responsibility for the offer and sale of the franchisor's franchises or the administrator of the franchised network, held such position with the franchisor for at least two years, and was in such position within 60 days of the purchase and sale of the franchise; or
- The investor is/was an owner of at least a 25% interest in the franchisor, maintained such ownership interest for at least two years, and had such ownership interest within 60 days of the purchase and sale of the franchise.⁵⁵

An insider who intends to operate the franchise as an entity is allowed to use the insider exemption.⁵⁶ The insider exemption is company-specific and only applies if the insider is purchasing a franchise of the company that employed the insider.⁵⁷ The exemption does not apply if the insider worked for a company that was an affiliate of the company selling the franchise.⁵⁸

> Minimum payment. The minimum payment exemption exempts franchise sales where "the total of the required payments, or commitments to make a required payment, to the franchisor or an affiliate that are made any time from before to within six months after commencing operation of the franchisee's business is less than \$540."⁵⁹ The FTC Compliance Guide explains that, for the purpose of calculating this six-month period, operations commence when the franchisee first makes its goods or services available for sale.⁶⁰ The FTC Compliance Guide also states that a commitment to make a payment more than six months after commencing operations (e.g., a non-negotiable promissory note with payments commencing only after the six-month period after start of operations) does not count toward the \$540 minimum, even if the commitment to pay is made during the six-month period.⁶¹

> Fractional franchise. A business relationship that is a fractional franchise is exempt from coverage under the FTC Franchise Rule.⁶² A fractional franchise relationship is created when an established product or service provider adds a franchised product or service to its then existing line of offered products or services. The fractional franchise exemption is only available if two conditions are met at the time the relationship is created.⁶³ First, the franchisee, any of its current directors or officers, or any current directors or officers of a parent or affiliate, must have more than two years of experience in the business represented by the franchise.⁶⁴ Second, the parties must have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20% of the franchisee's total dollar volume in sales for the first year of operation.⁶⁵

> Leased departments. The FTC Franchise Rule exempts leased department relationships where an independent retailer sells its own goods and services from premises leased from a larger retailer located in the larger retailer's store.⁶⁶ For the exemption to apply, the independent retailer must not be directly or indirectly required to purchase its goods or services from the larger retailer or suppliers required or approved by the larger retailer.⁶⁷

> **Oral agreements.** If the relationship between the parties is purely oral, it is exempt from coverage under the FTC Franchise Rule.⁶⁸ This exemption will not apply if there is any writing related to a material term, such as an invoice for goods or equipment.⁶⁹

> **Petroleum Marketing Practices Act.** The FTC Franchise Rule exempts petroleum marketers and resellers covered under the Petroleum Marketing Practices Act, such as gas station franchises.⁷⁰

Exclusions

The following relationships are outside the scope of the FTC Franchise Rule because they do not satisfy the elements of the definition of a franchise:⁷¹

> **Employer-employee and general partner relationships.** The FTC specifically excludes bona fide employer-employee and general partner relationships from coverage under the FTC Franchise Rule.⁷² The FTC will apply the right to control test to determine if an employer-employee relationship exists.⁷³ To qualify for the general partner exclusion, all partners of the general partnership must be general partners.⁷⁴

> **Cooperative associations.** The FTC Franchise Rule does not apply to: (a) agricultural cooperatives authorized by the Capper-Volstead Act, 7 USC § 291; and (b) retailer-owned cooperative chains.⁷⁵

> **Certification or testing services.** Arrangements with bona fide certification or testing services, such as that offered by Underwriters Laboratories, are excluded from coverage under the FTC Franchise Rule.⁷⁶

> **Single trademark licenses.** The FTC Franchise Rule does not apply to a trademark licensing arrangement where a single licensee is granted the right to use a trademark.⁷⁷ Examples of excluded relationships include: (a) a trademark license to a single licensee who manufactures trademarked goods to the licensor's specifications (i.e., trademark owners in the clothing industry often license the manufacture of textiles); (b) "collateral-license" arrangements where a trademark well known in one context is licensed for use in another context; and (c) a trademark license entered into in the context of settlement negotiations regarding trademark infringement litigation where a license is granted to the "infringing" party to use the trademark for a specified period.⁷⁸

FTC Business Opportunity Rule

An extended discussion of the FTC Business Opportunity Rule is outside the scope of this article. However, the applicability of the FTC Business Opportunity Rule should be analyzed when the business relationship is created.

If the business relationship is a business opportunity, the seller must provide specific disclosures to the prospective buyer before the sale is closed unless an exemption can be satisfied. Under the FTC Business Opportunity Rule, a "business opportunity" is defined as a continuing commercial relationship created by any arrangement or arrangements where each of the following elements are present:

1. A person ("business opportunity purchaser") offers, sells, or distributes to any person other than a "business opportunity seller" (defined below), goods, commodities, or services that are supplied by:
 - another person ("business opportunity seller"), or
 - a third person (i.e., supplier) with whom the business opportunity purchaser is directly or indirectly required to do business by another person ("business opportunity seller"); or
 - a third person (i.e., supplier) with whom the business opportunity purchaser is directly or indirectly advised to do business by another person ("business opportunity seller") where such third person is affiliated with the business opportunity seller;
2. The business opportunity seller secures for the business opportunity purchaser retail outlets or accounts for the goods, commodities, or services, or secures for the business opportunity purchaser locations or sites for vending devices or racks, or provides the services of a person to do either; and
3. The business opportunity purchaser is required as a condition of obtaining or commencing the business opportunity operation to pay or make a commitment to pay \$500 or more to the business opportunity seller or an affiliated person at any time before or within six months after the business opens in order to obtain or commence the business opportunity operation.⁷⁹

The FTC regulates business opportunities in a manner similar to franchises, requiring that certain pre-sale disclosures be made to a purchaser. Common examples of business opportunity ventures are vending machine routes, rack jobbing, and work-at-home businesses. Compliance with the FTC

Business Opportunity Rule is not required if the business opportunity complies with the disclosure requirements of the FTC Franchise Rule or falls under one of the exemptions of the FTC Franchise Rule.⁸⁰ As such, it is advisable to examine the exemptions and exclusions under both the FTC Franchise Rule and the FTC Business Opportunity Rule to determine whether the business relationship is subject to regulation.⁸¹

Definition of a "Franchise" Under State Law

The FTC Franchise Rule allows for state franchise laws that provide equal or greater protection than the FTC Franchise Rule. As such, it is critical to evaluate whether the business relationship satisfies the elements of the franchise definition under applicable state law—definitions that are often broader than the definition under the FTC Franchise Rule. As previously mentioned, 15 states have franchise registration and/or disclosure laws. The majority of these states define a franchise as a contract or agreement between two or more parties where: (1) the 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 the franchisor (marketing plan element); (2) the operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, 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.⁸²

In the state of California, the elements of the franchise definition are rearranged so that the "right" to engage in the business of offering, selling, or distributing goods or services is actually a fourth and separate prong.⁸³

The New York franchise definition materially differs from the definitions in other states because the imposition of a fee in connection with just one of the other two elements will satisfy New York's definition of a franchise.⁸⁴

Additionally, a minority of the state franchise laws do not include the marketing plan element of the franchise definition and instead analyze whether there is a "community of interest" between the franchisor and franchisee. Hawaii, Minnesota, Wisconsin,⁸⁵ and New Jersey⁸⁶ are examples of states that take the community of interest approach. In Wisconsin, the state Supreme Court identified the following two guidelines to determine whether a community of interest exists between the parties: (1) the business relationship between the parties must have a "continuing financial interest," and (2) there must be interdependence that includes a "likeness or similarity of interest in the common business" in which the parties are engaged.⁸⁷

The following is a description of the three elements found in the franchise definitions in the majority of the states with franchise laws:

> **Trademark.** The trademark analysis under state franchise laws is typically very similar to that of the federal law. The trademark element is often interpreted broadly and is easily satisfied. For instance, Illinois makes clear that the trademark element can be satisfied even when the Franchise Agreement is silent and does not grant the right to use the franchisor's mark.⁸⁸ In fact, an express contractual prohibition may not be sufficient unless the franchisor enforces the prohibition to ensure the mark is not being used.⁸⁹

In *Kim v. Servosnax, Inc.*,⁹⁰ a California court interpreted the trademark element very broadly, holding that a franchise relationship existed even though Kim was prohibited from using the marks under the agreement and never publicly displayed the marks. Servosnax developed a cafeteria in an office building pursuant to an agreement with the owner of the building and then licensed the completed cafeteria to Kim. The court found that Kim's use of the Servosnax name in discussions with the owner of the building was enough to establish the substantial association between the licensed business and the Servosnax mark, satisfying the trademark element of the state's franchise definition.

> **Franchise fee.** The fee element of state franchise definitions varies from state to state and can vary significantly from the FTC Franchise Rule. In many of these states, the payment of any amount is enough to satisfy the franchise fee element, not just payments in excess of \$540.⁹¹ Furthermore, many of these states do not limit the analysis to payments made during the first six months of business operation; a payment made at any time during the relationship is enough to satisfy the franchise fee element of the definition.⁹² Finally, courts in certain states have determined that the sum of a series of payments over a span of years satisfies the fee element.⁹³ As a result, it is often easier to satisfy the franchise fee element of a state's franchise definition than it is to satisfy the same element under the FTC Franchise Rule.

> **Marketing plan.**⁹⁴ The marketing plan analysis is similar to the analysis of the significant assistance or control element under the FTC Franchise Rule. To determine whether a marketing plan exists, the level of assistance or guidance provided by the franchisor must be analyzed. Under the Illinois franchise statute, the "marketing plan or system" definition focuses on the following factors,

without limitation: (1) specification of price, special pricing systems, or discount plans; (2) use of particular sales or display equipment or merchandising devices; (3) specific sales techniques; and (4) use of advertising or promotional materials or cooperation in advertising efforts.⁹⁵ In Indiana, a court held that there is no concrete test under the statute to determine whether a marketing plan exists, but the court said it would evaluate the nature of the franchisee's obligations under the agreement, focusing on any directives regarding the sale of goods or services.⁹⁶

Exemptions and Exclusions

The franchise laws in many states include exemptions or exclusions from the registration and/or disclosure requirements for business relationships that satisfy certain requirements. Exemptions and exclusions vary by state and include: (1) sophisticated investor exemptions; (2) large franchisor exemptions; (3) fractional franchise exemptions; (4) minimum payment exemptions; (5) exclusions for renewals of a franchise on substantially the same terms as the existing franchise; (6) exemptions for isolated sales; and (7) exclusions for franchise transfers that are not effected through the franchisor. In addition to varying by state, the exemptions and exclusions at the state level are not consistent with similar exemptions available under the FTC Franchise Rule. Finally, it is important to carefully examine the particular state exemption, as certain exemptions are from registration only and disclosure is still required.⁹⁷

Business Opportunities

Twenty-eight states⁹⁸ and the District of Columbia regulate the sale of business opportunities. Each state with a business opportunity law has a somewhat different definition of a business opportunity. But generally speaking, a business opportunity exists where (1) a seller furnishes goods or services, (2) for a payment (this requirement differs by state), (3) to enable the buyer to start (or, in certain states, operate) a business, and (4) the seller represents to the buyer any one or more of the following:

- the scheme will earn the buyer more income than the cost of the business opportunity;
- the seller will buy back all or a part of the buyer's output of products or services produced using the goods or services furnished by the seller (this provision differs substantially from state to state);
- the seller will find or help find locations for display racks, vending machines, coin-operated amusement devices, and so on;
- if the buyer becomes dissatisfied with the scheme, the seller will refund the initial payment or buy back what was sold to the buyer; or
- for a fee, the seller will provide a marketing or sales plan, except for marketing plans provided in conjunction with a registered trademark (this provision varies substantially from state to state).⁹⁹

As previously stated for the federal business opportunity regulation, an extensive discussion of the state business opportunity regulations is beyond the scope of this article. However, the applicability of the state business opportunity regulations should be examined when the business relationship is formed to determine whether the relationship is regulated under such state regulations and, if so, to determine whether an exemption is available.

Penalties for Violating Franchise Laws

The FTC enforces the FTC Franchise Rule under §§ 5, 13(b), and 19 of the FTC Act.¹⁰⁰ The FTC can seek injunctive relief in connection with violations of the FTC Franchise Rule.¹⁰¹ Furthermore, the FTC can initiate civil actions to pursue remedies including rescission of the contract, refunds, payment of damages, or public notification of the unlawful acts.¹⁰² In connection with such civil actions, the FTC may pursue a maximum fine of up to \$16,000 for each violation of the FTC Franchise Rule.¹⁰³ Individuals may not assert private causes of action for violations of the FTC Franchise Rule.¹⁰⁴

At the state level, a variety of penalties may be imposed for violations of state franchise laws. State regulators can pursue civil actions against those who violate state franchise laws¹⁰⁵ and, in contrast to federal law, individuals can pursue private causes of action.¹⁰⁶ Franchise-related claims most often arise when the putative franchisee is disgruntled and brings an action against the other party. Penalties for violating state franchise laws can include monetary fines, damages, injunctions, rescission, and termination of the entity's right to conduct business within the state, among other consequences.¹⁰⁷ Finally, state franchise laws may also provide for criminal penalties for violations of state franchise law.¹⁰⁸

Conclusion

The network of federal and state franchise regulations is complex, far-reaching, and inconsistent. Because the penalties for violations of the applicable franchise laws can be damaging and costly, a careful review of the regulations prior to establishing a business relationship is essential. Depending on the jurisdiction, failure to properly assess the nature of the business relationship can result in the recovery of damages (including attorney fees in some cases), rescission of the contract, and other penalties. Alternatively, if a client is considering expansion of its business using a franchise model, it is important to be aware of the various franchise regulations, requirements, and processes to avoid costly surprises in the future.

Notes

1. Bus. Franchise Guide (CCH) ¶ 6203; 44 Fed. Reg. 49,966 (Aug. 24, 1979).
2. 16 CFR § 436.
3. The FTC Franchise Rule requires that a prospective franchisee must be furnished with the franchise disclosure document "at least 14 calendar days before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or an affiliate in connection with the proposed franchise sale." 16 CFR § 436.2(a). A franchise seller must furnish a prospective franchisee with a copy of the FDD earlier in the sales process if the prospective franchisee makes a "reasonable request" for a copy of the FDD. *Id.* at § 436.9(e).
4. 16 CFR § 436.5(v).
5. *Id.* at § 436.10(b).
6. California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.
7. California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.
8. Md. Code Ann., Bus. Reg. § 14-203.
9. See, e.g., Cal. Bus. & Prof. Code § 20001; Conn. Gen. Stat. § 42-133e(b).
10. 16 CFR § 437.
11. Alaska, Arizona, California, Connecticut, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia, and Washington.
12. Alabama and Tennessee.
13. See, e.g., N.H. Rev Stat. Ann. § 358-E:3.V; Okla. Stat. tit. 71 § 803(6); Ohio Rev. Code Ann. § 1334.13.
14. See, e.g., Ga. Code Ann. § 10-1-410; N.C. Gen. Stat. § 66-94.
15. 16 CFR § 436.1(h).
16. "The term 'trademark' is intended to be read broadly to cover not only trademarks, but any service mark, trade name, or other advertising or commercial symbol." FTC, Franchise Rule Compliance Guide at 2 (May 2008), www.ftc.gov/tips-advice/business-center/guidance/franchise-rule-compliance-guide.
17. *Id.*; Bus. Franchise Guide (CCH) ¶ 6205; 44 Fed. Reg. 49,966 (Aug. 24, 1979).
18. U.S. Marble, Inc., Bus. Franchise Guide (CCH) ¶ 6424 (Oct. 9, 1980). Coverage under the FTC Franchise Rule can be avoided by the supplier if it expressly prohibits the distributor from using its mark. FTC, *supra* note 16 at 2.
19. U.S. Marble, Inc., Bus. Franchise Guide (CCH) ¶ 6424 (Oct. 9, 1980). See also FTC, *supra* note 16 at 2.
20. *Id.*
21. FTC, *supra* note 16 at 2.
22. *Id.*
23. *Id.*
24. *Id.* at 3. According to the FTC, the following factors are considered, to a lesser extent, when determining whether significant control or assistance exists: (1) a requirement that a franchisee service or repair a product (except warranty work); (2) inventory controls; (3) required displays of goods; and (4) on-the-job assistance with sales or repairs. *Id.* at 3-4.

25. *Id.* at 3.
26. *Id.* at 4.
27. *Id.*
28. *Id.*
29. 16 CFR § 436.1(s).
30. FTC, *supra* note 16 at 5.
31. *Id.*
32. *Id.* at 5-6.
33. 16 CFR § 436.1(s).
34. FTC, *supra* note 16 at 6.
35. *Id.*
36. *Id.*
37. Bus. Franchise Guide (CCH) ¶ 6207; 44 Fed. Reg. 49,966 (Aug. 24, 1979).
38. Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities, Statement of Basis and Purpose, 72 Fed. Reg. 15,444, 15,466 (Mar. 30, 2007) (hereinafter, Statement of Basis and Purpose).
39. Bus. Franchise Guide (CCH) ¶ 6207; 44 Fed. Reg. 49,966 (Aug. 24, 1979).
40. 16 CFR § 436.8(a)(5) and (6).
41. *See, e.g.*, Cal. Corp. Code §§ 31106, 31109.
42. Statement of Basis and Purpose, *supra* note 38 at 15,523.
43. *Id.*
44. 16 CFR § 436.8(a)(5)(i). *See* 77 Fed. Reg. 36149 (June 18, 2012) (adjusting the monetary thresholds). The FTC Franchise Rule requires the FTC to adjust the size of the monetary threshold every fourth year based on the Consumer Price Index. 16 CFR § 436.8(b).
45. 16 CFR § 436.8(a)(5)(i). The FTC Franchise Rule requires that the acknowledgment state: "The franchise sale is for more than \$1,084,900—excluding the cost of unimproved land and any financing received from the franchisor or an affiliate—and thus is exempted from the Federal Trade Commission's Franchise Rule disclosure requirements, pursuant to 16 CFR 436.8(a)(5)(i)." *Id.*
46. FTC, *supra* note 16 at 12.
47. *Id.* at 10.
48. Statement of Basis and Purpose, *supra* note 38 at 15527.
49. 16 CFR § 436.8 (a)(5)(ii). *See* 77 Fed. Reg. 36149 (June 18, 2012) (adjusting the monetary thresholds). The FTC Franchise Rule requires the FTC to adjust the size of the monetary threshold every fourth year based on the Consumer Price Index. 16 CFR § 436.8(b).
50. FTC, *supra* note 16 at 13.
51. *Id.*
52. *Id.*
53. *Id.*
54. Statement of Basis and Purpose, *supra* note 38 at 15528.
55. 16 CFR § 436.8(a)(6).
56. Statement of Basis and Purpose, *supra* note 38 at 15529, n. 864.
57. *Id.* at 15529.
58. *Id.*
59. FTC, *supra* note 16 at 7.
60. *Id.*

61. *Id.*
62. 16 CFR § 436.8(a)(2).
63. 16 CFR § 436.1(g).
64. *Id.*
65. *Id.*
66. 16 CFR § 436.8(a)(3); FTC, *supra* note 16 at 9.
67. FTC, *supra* note 16 at 9.
68. 16 CFR 436.8(a)(7).
69. FTC, *supra* note 16 at 9.
70. *Id.*; 16 CFR § 436.8(a)(4).
71. Statement of Basis and Purpose, *supra* note 38 at 15529-15530.
72. FTC, *supra* note 16 at 15.
73. *Id.*
74. *Id.*
75. *Id.* at 16.
76. *Id.*
77. *Id.*
78. *Id.*
79. 16 CFR § 437.2(a).
80. *Id.* at § 437.2(a)(3)(v).
81. *Id.* at § 437.2(a)(3-4).
82. *See, e.g.*, 815 Ill. Comp. Stat. § 705/3-1.
83. In California, the definition of franchise is interpreted as a four-prong definition. If the franchisee/investor does not have the right to "engage in the business of offering, selling or distributing goods or services," the relationship is not a franchise. According to an official release entitled "When Does an Agreement Constitute a 'Franchise?'" that interprets the California Franchise Investment Law (CFIL), if an agreement designates a person as a "franchisee," involves the payment of a "franchise fee," but does not grant the right to operate or participate in the operation of a business, such agreement is not a franchise. Bus. Franchise Guide (CCH) ¶ 5050.45. In a California case that examined this prong of the definition, the court found that a franchise existed because the plaintiffs (franchisees) were more than just sales representatives taking orders without authority to bind the franchisor (plaintiffs solicited orders, demonstrated products, solved customer problems, installed Safeguard systems, maintained contact with customers, generated business, provided ongoing services to customers, occasionally distributed Safeguard's goods, set prices on certain products, and in some cases guaranteed customer payment) and the other prongs of the definition were satisfied. *Gentis v. Safeguard Bus. Systems, Inc.*, 60 Cal.App.4th 1294 (Cal.App. 1998).
84. N.Y. Gen. Bus. Law § 681(3).
85. Wis. Stat. § 135.02.
86. N.J. Rev. Stat. § 56:10-3. New Jersey's definition is found in the state's relationship termination law.
87. *Ziegler Co. v. Rexnard, Inc.*, 407 N.W.2d 873, 879 (Wis. 1987), *on recons.*, 433 N.W.2d 8 (Wis. 1988).
88. Ill. Admin Code tit. 14, § 200.103.
89. *Id.*
90. 10 Cal. App. 4th 1346 (Cal.Ct.App. 1992).
91. *See, e.g.*, Cal. Corp. Code § 31011; Cal. Bus. & Prof. Code §§ 20001 and 20007; Haw. Rev. Stat. § 482E-2; Haw. Rule § 16-37-1.

92. *Id.*

93. *To-Am Equip. Co., Inc. v. Mitsubishi Caterpillar Forklift Am., Inc.*, 152 F.3d 658, 662 (7th Cir. 1998).

94. Certain states evaluate whether there is a "community of interest" in lieu of using the marketing plan prong of the definition. These states generally define "community of interest" to mean a continuing financial interest between the franchisor and the franchisee in the operation of the franchise business whereby the franchisor derives direct or indirect financial benefit from the franchisee's success. The meaning of "community of interest" varies from state to state, is fact specific and often defined by case law.

95. 815 Ill. Comp. Stat. § 705/3-18.

96 *Horner v. Tilton*, 650 N.E.2d 759, 762 (Ind.Ct.App. 1995).

97. *See, e.g.*, Md. Code Ann. Reg. § 14-214(b); Md. Regs. Code tit. 02 § 02.02.08.10; R.I. Gen. Laws § 19-28.1-6.

98. States with business opportunity laws: Alaska, Arizona, California, Connecticut, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia, and Washington. Alabama, Tennessee, and the District of Columbia regulate business opportunities through consumer protection laws.

99. *See, e.g.*, Cal. Civ. Code § 1812.201; Md. Code Ann. Bus. Reg. § 14-101(b).

100. 16 CFR §§ 436.2, 436.6(a).

101. 15 USC § 53(b).

102. 15 USC § 57(b).

103. 15 USC § 45(m)(1)(A). *See* 45 Fed. Reg. 13539 (Mar. 11, 2014) (increasing penalty to \$16,000).

104. *G&R Moojestic Treats, Inc. v. Maggiemoo's Int'l, LLC*, Bus. Franchise Guide (CCH) ¶ 12,826 (S.D.N.Y. 2004).

105. Cal. Corp. Code § 31400(a); Haw. Rev. Stat. § 482E-10.5; 815 Ill. Comp. Stat. 705/22(a-b); Wash. Rev. Code § 19.100.210.

106. Cal. Corp. Code § 31300; Haw. Rev. Stat. § 482E-9(b); 815 Ill. Comp. Stat. 705/26; Wash. Rev. Code § 19.100.190(2); Md. Code Ann., Bus. Reg. § 14-227(b).

107. California allows franchisees to recover damages and seek rescission for willful violations of California franchise law. Cal. Corp. Code § 31300. Illinois permits courts to issue injunctions, award damages or restitution, and terminate an entity's ability to conduct business in the state. 815 Ill. Comp. Stat. 705/22(b). In Maryland, the commissioner may seek injunctive relief, revoke or suspend the company's charter, dissolve the entity if formed in Maryland, suspend or terminate the right to do business in Maryland, seek restitution, pursue a restraining order, award damages to the injured party, or appoint a receiver or conservator. Md. Code Ann., Bus. Reg. § 14-210(b)(3).

108. Willful violators of California franchise law may face imprisonment for up to one year. Cal. Corp. Code § 31410. Persons who are convicted of violating Hawaii franchise law face a one-year term of imprisonment. Haw. Rev. Stat. § 482E-10.6. A willful violator of Washington franchise law is guilty of a class B felony and may be imprisoned for up to 10 years. Wash. Rev. Code § 19.100.210 (3).