



THE ACCIDENTAL FRANCHISE

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THE ACCIDENTAL FRANCHISE

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THE ACCIDENTAL FRANCHISE

by Mark A. Kirsch and Rochelle B. Spandorf*

I. THE REGULATION OF FRANCHISE RELATIONSHIPS

A. An Historical Perspective of Franchising

The word *franchise* comes from the old French, meaning *privilege* or *freedom*.¹ Throughout history, *franchise* has been used to denote a broad spectrum of special commercial arrangements.

In medieval times, the Catholic Church would grant franchises to officials, conferring authority to collect taxes for the Pope and to keep a portion of their collections.² In the Middle Ages, the local sovereign or lord would grant franchises, giving the right to hold markets or fairs, operate the local ferry, or hunt on his land.³ The early common law uses the term to refer to privileges granted by a sovereign in return for payments or responsibilities.⁴

As centuries passed, national economies evolved and so did the franchise concept. In 1840, in Germany, major brewers granted franchises to certain taverns conferring exclusive rights to sell their ale.⁵

In the United States, in 1851, I. M. Singer & Co. inadvertently created the first franchise network to distribute its sewing machines.⁶ Later in the 1800s, cities started granting monopoly franchises for streetcar and utility services. As our nation became more industrialized around the turn of the 20th Century, nationally known brands and manufacturers emerged and our economy became consumer-centric. The earliest franchises from this time were product franchises, focused mainly on the burgeoning oil, automobile, and soft drink industries.

Modern franchising came of age following World War II, buoyed by the post-war economy. Franchising's most famous landmarks, Holiday Inn, Dunkin Donuts, McDonalds, and

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¹ Merriam Webster's Collegiate Dictionary, 464 (10th ed. 1997).

² Stan Luxenberg, *Roadside Empires: How The Chains Franchised America* at 14 (1985) [hereinafter, *Roadside Empires*].

³ *Id.*

⁴ *See State v. Real Estate Bank*, 5 Ark. 595; 41 Am. Dec. 109 (Ark. 1844) (discussing franchise as grant of privilege from king within context of quo warranto proceedings in 17th Century England.); *People v. Utica Ins. Co.*, 15 Johns. 358; 8 Am. Dec. 243 (N.Y. 1818) (discussing franchise as a royal privilege by grant from Crown in 17th Century England).

⁵ History of Franchising (2000), at <http://www.franinfo.com/history.html> (last modified June 13, 2000).

⁶ *Franchising: A Brief History*, at <http://www.wdfi.org/fi/securities/franchise/history.htm>; Wisconsin Department of Financial Institutions (last visited August 28, 2001); *see, e.g., Roadside Empires supra* note 2 at 17.

Kentucky Fried Chicken, to name a few, were launched during this period.⁷ From 1950 to 1965, franchised locations increased by 350% and new franchise concepts increased by 1200%.⁸

The explosive growth of franchising was accompanied by well-documented abuses in franchise sales practices.⁹ In response, Congress began studying franchising in the mid-1960s. A public record slowly emerged resounding a common theme: financially unstable and inexperienced franchisors, high pressure sales tactics, hidden fees and undisclosed kick-backs, unfulfilled promises of services and training, and, in some cases, outright trickery.¹⁰ Franchisees, as a group, were found to be largely “unsophisticated,” highly susceptible, and ill-suited for a field requiring “a significant degree of business acumen.”¹¹ Accompanying the parties’ economic disparity was a severe informational imbalance, making prospects easy prey for sharp selling practices.¹² This was the setting and context marking modern franchising’s beginning.

B. The Regulatory Scheme

Franchising grew dramatically in the post-war years in a completely *laissez-faire* legal environment. California was the first state to react to the documented selling abuses by enacting its Franchise Investment Law in 1970.¹³ Patterned after federal securities laws,¹⁴ the California statute adopted an elaborate pre-sale disclosure and government registration system enforced through private (civil and criminal) and administrative remedies.

California’s move set off a chain reaction of state regulatory activity and lead to a judicial awakening to franchising as a distinct business model and legal relationship. Today, 11 states have a pre-sale full-review registration system modeled after California’s law, another three states impose a simpler notice filing requirement, and a total of 16 states and two U.S. territories

⁷ *Franchising: A Brief History*, at <http://www.wdfi.org/fi/securities/franchise/history.htm>; Wisconsin Department of Financial Institutions.

⁸ See Statement of Basis and Purpose Relating to Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures Chap. III, 43 Fed.Reg. 59621, 59624 (1978), Bus. Franchise Guide (CCH) ¶¶ 6300 et seq. [hereinafter, Statement of Basis and Purpose].

⁹ Statement of Basis and Purpose, Bus. Franchise Guide (CCH) ¶ 6304.

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ The California Franchise Investment Law became effective January 1, 1971. See Cal. Corp. Code §§ 31000-31516 (West 1989). CFIL § 31001 expresses the law’s purpose, “. . .to provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered.”

¹⁴ See *Keating v. Superior Court*, 31 Cal. 3d 584, 597; 645 P.2d 1192, 1199 (1982), Bus. Franchise Guide (CCH) ¶ 7846. The California Supreme Court reasoned that “[t]he evidence is persuasive that in drafting the Franchise Investment Law, California legislators looked to the Securities Act of 1933 as their model.” California’s highest court held that certain claims under the Franchise Investment Law were not subject to mandatory arbitration pursuant to the arbitration provision in the parties’ franchise agreement. The U.S. Supreme Court overruled the holding in *Southland Corp. v. Keating*, 465 U.S. 1 (1984), Bus. Franchise Guide (CCH) ¶ 8112. The U.S. Supreme Court has similarly overruled decisions forbidding arbitration of claims arising under the Securities Act of 1933. See also, e.g., *Rodriguez de Quijas v. Shearson/Am. Exp.*, 490 U.S. 477 (1989).

(some of which also regulate franchise sales) have laws addressing substantive aspects of franchise relationships, focusing mainly on termination, transfer and renewal issues.¹⁵

The federal government did not begin regulating franchises until October, 1979, when the Federal Trade Commission's pre-sale disclosure rule took effect.¹⁶ The FTC Rule follows the California model to the extent of requiring franchisors to make detailed disclosures to prospective investors, but neither imposes any registration or filing duty nor confers private remedies on franchisees.¹⁷

¹⁵ California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin impose pre-sale registration filing requirements and are sometimes collectively referred to as *registration states*. Indiana, Michigan, and Wisconsin simplify the process by making registration immediately effective upon filing the registration application with a designated state agency (in Michigan, franchisors need file only a one-page notice). In the other registration states, the registration application is subject to a lengthy review process. While most of the registration states pattern their laws on California's, each state's regulatory scheme differs in its details, leaving franchisors to contend with an uneven patchwork of registration rules and procedures.

The remaining states with no specific pre-sale franchise law are sometimes collectively referred to as *non-registration states*. Florida, Kentucky, Nebraska, Texas and Utah require franchisors to file a one-page exemption notice to gain exemption from the state's business opportunity law. See discussion of business opportunity laws *infra* in the text.

Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Washington, Wisconsin and the territories of Puerto Rico and the Virgin Islands each have statutes of general applicability to franchise relationships. General franchise relationship laws are non-industry specific. Additionally, there are assorted special industry laws that regulate petroleum marketers, automobile dealerships, liquor and wine distributorships, equipment dealers, and similar industry-specific distribution programs.

This article's focus is the *accidental franchise*. Therefore, the article concentrates on statutes of general applicability to franchises. Statutes regulating other kinds of commercial relationships, like business opportunity statutes, are discussed more briefly.

For an exceptional overview of the entire regulatory scheme, see FUNDAMENTALS OF FRANCHISING, ABA Forum on Franchising (1997) [hereinafter, Fundamentals].

¹⁶ Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. §§ 436.1-3 (1978) [hereinafter, the FTC Rule].

¹⁷ Enforcement of the FTC Rule is accomplished strictly through FTC enforcement actions. The Rule does not confer a private right of action. See, *Banek, Inc. v. Yogurt Ventures U.S.A., Inc.*, 1992 U.S. Dist. LEXIS 21453 (E.D. Mich. 1992), Bus. Franchise Guide (CCH) ¶ 10,112. On July 9, 2001, the FTC reported on its enforcement activities between 1993-2000. Its report disclosed that three-fourths of all complaints received by the agency during this period concerned business opportunity ventures and only 6% involved relationships clearly identifiable as franchises (the remaining complaints could not be classified). Agency-initiated investigations were overwhelmingly aimed at business opportunity schemes (82% to 18%). Of the 59 franchise investigations, 22 resulted in actual cases. A separate General Accounting Office study of FTC Rule enforcement, "Federal Trade Commission: Enforcement for the Franchise Rule," GAO-01-776, was issued on July 31, 2001. The GAO report, which covered the period 1993-99 reported similar results: over 90% of the 3680 complaints received by the FTC were business opportunity related (and less than 10% were franchise-related); and of the 332 investigations launched by the FTC, the FTC proceeded to court in 162 cases with claims of violations of the FTC Rule or FTC Act § 5, and of those 162 cases, over 85% involved business opportunity ventures, and less than 15% involved franchises. For more information, see <http://www.gao.gov/new.items/d01776.pdf> (July 31, 2001; last visited August 28, 2001).

The pre-sale disclosure process embraced by federal and state jurisdictions entails supplying prospects with comprehensive information about the franchisor's franchising experience, litigation and bankruptcy history, and financial condition, essential contractual obligations, detailed information about fees and initial investment costs, recent franchisee statistics, and identity of current franchisees.¹⁸

These laws forbid franchisors to require prospects to pay any consideration for the franchise (even a refundable deposit), or sign any binding commitment (even a cancelable option) until they deliver a comprehensive prospectus, the Uniform Franchise Offering Circular (UFOC) and wait a minimum time period (currently, 10 business days).¹⁹ The UFOC not only includes the elaborate disclosures, but all of the franchise contracts that the prospect must sign, and three years of the franchisor's audited financial statements.

As noted, a franchisor satisfies the FTC Rule by timely delivering an accurate and complete UFOC (no federal filing is required). Registration states increase the franchisor's burden by also conditioning the right to offer or sell franchises in the state on a state agency's review and approval of the franchisor's disclosure documents and financial condition.²⁰ Franchisors must keep their state registrations current through annual and interim filings if they want to continue to sell new franchises to state residents or for locations in the state.²¹

The first franchise relationship law pre-dates California's franchise sales law by seven years.²² While most relationship laws focus on requiring good cause to terminate a franchise, refuse to approve a transfer request, or cancel a renewal option, several states regulate franchise

¹⁸ For an excellent explanation of the fundamentals of franchise disclosure, see the chapter on *Franchise Disclosure Issues* written by Judith Bailey and Dennis Wieczorek in *Fundamentals*, *supra* note 15.

The North American Securities Administrators Association, an unofficial association of state securities and franchise regulators, has authored a uniform franchise disclosure format, referred to as the Uniform Franchise Offering Circular, or UFOC. The guidelines for preparing the UFOC appear at *Bus. Franchise Guide (CCH) ¶ 5750 et seq.*

The FTC and all registration states accept the UFOC disclosure format. While the FTC Rule contains an alternative disclosure format, some registration states do not accept it. Consequently, few franchisors have ever used the FTC's disclosure format. Pending amendments to the FTC Rule would eliminate the FTC disclosure format entirely. The amendments would also modify certain aspects of the UFOC disclosure format. FTC Notice of Proposed Rulemaking, 64 Fed. Reg. 204 at 57296-97 (October 22, 1999) [hereinafter, FTC NPR].

¹⁹ Pending amendments to the FTC Rule propose to change the waiting period from 10 *business* days to 14 days and to eliminate the FTC Rule's *first personal meeting* delivery requirement. FTC NPR, *supra* note 18 at 57300-01.

²⁰ Nearly every registration state augments the basic UFOC disclosure format by requiring additional disclosures about state-specific laws applicable to franchises operating in the state.

²¹ For a comprehensive discussion of the franchise registration scheme, see the chapter on *Franchise Registration* written by Rochelle B. Spandorf and Mark B. Forseth in *Fundamentals*, *supra* note 15. In addition to explaining the mechanics of registration, the chapter addresses the dual federal and state regulatory system, jurisdictional issues, and federal preemption of state laws.

²² In 1964, Puerto Rico passed the first non-industry specific relationship law protecting all dealers. For an excellent overview of franchise relationship laws, see the chapter on *Franchise Relationship Laws* written by Thomas M. Pitegoff and M. Christine Carty in *Fundamentals*, *supra* note 15.

relationships more extensively by prohibiting a number of other franchisor practices, including imposing restrictions on franchisees' right to freely associate, discriminating among franchisees, encroaching on a franchisee's market area, restricting supply sources, and requiring franchisees to litigate or arbitrate out-of-state.

There is far wider variation among franchise relationship laws than among franchise sales laws. Despite well-organized lobbying efforts by franchisee advocates, there is yet no federal relationship law applicable generally to franchises.²³

Not infrequently, discovering that a commercial arrangement is a franchise comes years after the parties first come together, when the franchisor tries to end the relationship unilaterally pursuant to an *at will* termination provision or engages in other conduct that offends a statute's prescript. The inadvertent franchisor's lesson may come at a tremendous price, not just in the relief awarded to the immediate victim, but to the network. An adverse ruling can destabilize the network's *status quo* by setting off a chain reaction from similarly situated dealers or licensees or by tilting negotiating leverage in their favor.

The consequences of not complying with franchise laws are serious and substantial, including possible personal and criminal liability. Regulators' enforcement authority can result in drastic measures, including ordering restitution, rescission, and restraints against future franchise sales. Statutory violations can devastate a franchise system, or an accidental franchise system.

C. The Franchise Definition

Given the regulatory purpose, franchise legislation hinges on defining which commercial arrangements should be regulated. The bulk of Congress' record in studying franchising before passing the FTC Rule shows Congress' preoccupation with devising a proper definition of a *franchise*. Congress' principal goal was to balance competing consumer concerns and industry interests which respectively (and predictably) pressed for, and resisted, protective legislation. For the same reason, this article's exploration of accidental franchises focuses largely on the legal definition of a franchise.

Commercial arrangements are regulated as franchises only if they fit within a statutory definition, as franchises are strictly creatures of statute. The franchisor's intent to form a

²³ Since 1992, there have been 11 separate proposals to enact a general federal relationship law ("Small Business Franchise Act") introduced in Congress; all have failed. There have been two federal special industry relationship laws in place for some time, one protecting automobile dealers (the Automobile Dealer's Day in Court Act, 15 U.S.C. §§ 1221-25), and the other gasoline dealers (the Petroleum Marketing Practices Act, 15 U.S.C. §§ 2801).

franchise is not a definitional prerequisite,²⁴ nor is a franchisor's ignorance of the law a legal excuse for non-compliance.²⁵

Furthermore, a relationship's legal significance "is fixed by reality, not by what [the parties] call it, though descriptive language may be relevant."²⁶ In addition to oral and written promises, course of dealing evidence is highly probative.²⁷

While federal and state jurisdictions share common definitional approaches, there is no universal definition of a *franchise*. Moreover, each jurisdiction has its own mix of definitional exclusions and exemptions. What qualifies as a franchise under federal law may not meet a state law definition, or vice-versa. What is a franchise in one state, may not be a franchise in all of the regulating states in which the franchisor operates.²⁸

At the most basic level, a franchise is defined by the co-existence of three elements:

A grant of rights to use another's trademark to offer, sell or distribute goods or services (the *grant* or *trademark* element),

Significant assistance to, or control over, the grantee's business, which may take the form of a prescribed marketing plan (the *marketing plan* element), and

Payment of a required fee (the *fee* element).

Practitioners and their clients are frequently surprised by the broad sweep of franchise laws and the diversity of commercial relationships which they snare. The uninformed tend to associate the term *franchise* with a singular business model, the traditional chain of uniformly

²⁴ Likewise, "a party cannot avoid a franchise relationship merely by disclaiming its existence." *Peter v. Stone Park Enterprises, LLC*, 1999 U.S. Dist. LEXIS 11385 at 19 (N.D. Ill. 1999), Bus. Franchise Guide (CCH) ¶ 11,750.

²⁵ Consistent with the securities laws after which franchise laws are modeled, and in furtherance of their consumer protection purpose, franchise statutes are considered strict liability statutes. *See Video Update, Inc. v. Guenther*, 741 F. Supp. 172, 174 (D. Minn. 1990), Bus. Franchise Guide (CCH) ¶ 9694 (video rental franchisee awarded rescission of franchise agreement and relief from outstanding defaults based on franchisor's failure to furnish current UFOC in violation of Illinois' franchise sales law).

²⁶ *Hartford Electric Supply Co. v. Allen-Bradley Co.*, 736 A.2d 824, 250 Conn. 334, 348 (1999), Bus. Franchise Guide (CCH) ¶ 11,685 (quoting *Petereit v. S.B. Thomas, Inc.*, 853 F. Supp. 55, 60 (D. Conn. 1993), *aff'd in part, rev'd in part*, 63 F. 3d 1169 (2d Cir. 1995), *cert. denied*, 517 U.S. 1351 (1996), Bus. Franchise Guide (CCH) ¶ 10,741.

²⁷ The FTC Rule excludes purely oral agreements from its franchise definition. FTC Rule, *supra* note 16 at § 436.2(a)(3)(iv). However, most state definitions apply to both oral and written contracts. *See Chem-Tek, Inc. v. General Motors Corp.*, 816 F. Supp. 123, 125 (D. Conn. 1993) (finding franchise under Connecticut law based on oral and written representations and a long established course of dealing).

²⁸ *See, e.g., In re The Matterhorn Group, Inc.*, 2000 Bankr. LEXIS 915 at 30 (U.S. Bankr. Ct. S.D. N.Y. 2000), (noting that New York's franchise definition is broader than most jurisdictions' in that it requires either a marketing plan or substantial association with the grantor's trademark, but not both).

operated retail establishments sharing a common trade name. In some cases, labels, like licensor and licensee or comparable designations, mask the problem.²⁹

Business owners and their advisors are not the only ones confused. Irreconcilable administrative and judicial precedent over the years reflect misperceptions and hesitation about the franchise concept among regulators and judges as well.³⁰ As a result, legislators, regulators, judges, and practitioners, alike, suffer from a logical equivocation over the kinds of commercial arrangements that should be regulated as franchises.

As this article explains, numerous accidental franchises operate in today's economy waiting to be discovered by a regulator or unhappy investor. Many of these arrangements look nothing like the mom and pop small business opportunities for which the laws were originally drafted 20 to 30 years ago, or may involve industries unimagined back then.

For this reason, in advising companies that distribute products or services, or license business methods to independent operators, such as distributors, dealers, licensees, sales agents, strategic partners, alliance members, affiliates, consultants, or the like, practitioners must consult the statutes, judicial opinions and administrative guides of each relevant jurisdiction. The commercial relationship's substance controls its legal status, not the labels which the contract assigns to the parties.

Understanding definitional nuances also enables practitioners to counsel their clients about the possibility of alternative business models structured to omit one of the definitional elements. As explained in Sections III and IV, below, for some commercial arrangements, simple adjustments can be made to keep the program safe from legal regulation. For others, however, structural alternatives may not be possible without sacrificing a program's core business or economic goals.

The definitional elements and jurisdictional differences in defining the target of franchise laws are discussed below.

²⁹ Not all inadvertent franchisors are innocent about the scope of franchise laws. Some may know full well that the opportunities they are pedaling are franchises or business opportunities giving rise to legal duties which they chose to ignore for any number of reasons. Some inadvertent franchisors may be less calculating, but equally shortsighted, relying on the fact that none of their competitors comply with franchise regulations.

³⁰ The lack of a coherent conceptual understanding of franchises as a distinct business model is the reason for the "increasingly incoherent and unworkable interpretations" of franchise definitions, says one author. Stephen C. Root, *The Meaning of "Franchise" Under the California Franchise Investment Law: A Definition in Search of a Concept*, 30 McGeorge L. Rev. 1164, 1188 (Summer, 1999) [hereinafter, *The Meaning of "Franchise"*]. The author, quoting from Robert W. Emerson, *Franchise Contract Clauses and the Franchisor's Duty of Care Toward Its Franchisees*, 72 N.C.L. Rev. 905, 913, n.16., concludes: "In short, the imperfect statutory and regulatory definitions add to the definitional ambiguities and contradictions found in the case law. Together, the statutes, regulations and case law reinforce the parties' uncertainty about what exactly is the legal relationship between a franchisor and its franchisees."

While the conceptual confusion may explain the existence of so many accidental franchises, certain aspects of franchise definitions are better understood than others and can be relied on to structure business models that avoid regulation as a franchise, as discussed in the text.

1. *Federal Law*

The FTC Rule describes three general types of franchises: package, product, and business opportunity franchises.³¹

The first two types are best known and, as one commentator observed, any distinction between them is “more academic than legally significant.”³² The package franchisee adopts the franchisor’s business format, and identifies its independent operation by the franchisor’s trademarks, in exchange for which the franchisee pays the franchisor a fee. The franchisee’s operating methods are subject to significant control by the franchisor or, alternatively, the franchisor renders significant assistance to the franchisee in day-to-day operations. Fast food, convenience stores and real estate services are examples of package franchises.

The product franchisee distributes goods identified by the franchisor’s brand manufactured by, or for, the franchisor. The franchisee pays a fee for the distribution rights above the wholesale price of the goods. As with package franchises, the franchisor exercises significant control over, or provides significant assistance to, the franchisee. Automobile and gasoline dealerships are examples of product franchises.

The presence of three basic elements mark both package and product franchises: (1) the right to distribute goods or services associated with or identified by the franchisor’s marks, (2) significant control over, or significant assistance to, the franchisee, and (3) a direct or indirect required payment.³³

The third type, business opportunity ventures, encompasses readily distinguishable lower-cost investments such that the FTC has announced that it will sever these from the FTC Rule and regulate them separately once the pending Rule amendments complete the bureaucratic review process.³⁴ While business opportunity franchisees, like package and product franchisees, distribute goods or services supplied by, or for, the franchisor and receive significant assistance from the franchisor in terms of securing locations, outlets or accounts, their businesses are not necessarily associated with the franchisor’s trademarks.³⁵

2. *State Law*

State law franchise definitions largely resemble the FTC Rule’s package and product franchise definitions in that most also require the combination of three basic elements. The

³¹ See Interpretive Guides to Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966 (1979), Bus. Franchise Guide (CCH) ¶ 6203 [hereinafter, Interpretative Guides].

³² Martin D. Fern, *Establishing and Operating Under a Franchise Relationship*, § 1.02[1] (1986).

³³ FTC Rule at § 436.2(a)(i), *supra* note 16.

³⁴ FTC NPR *supra* note 18 at 57296. At the time this paper was submitted for publication, the pending Rule amendments had not completed the rule-making process. Their likely enactment date continues to get pushed back, and will probably not be before 2003.

³⁵ Examples of business opportunity ventures include vending machine routes and rack jobbers.

federal *grant* and *fee* elements are fundamentally the same, however, state franchise laws replace the middle definitional element of *substantial assistance or control* either with the requirement that there be a *marketing plan prescribed in substantial part by the franchisor*,³⁶ or a *community of interest* between the parties.³⁷

The individual definitional elements of federal and state law are explained below.

a. Grant or Trademark Element

The grant of rights to associate with another's trademarks in distributing goods or services is a common element of all franchise definitions.³⁸ It is also the most easily satisfied of the three definitional elements. Absent an express prohibition against use of the grantor's trademark,³⁹ a right to use the mark will be inferred even if the mark is, in fact, never used.⁴⁰

State definitions vary from requiring a *license to use* the grantor's mark to requiring a *substantial association* between the grantee's business and the grantor's trademark. Under the license approach, an express contract authorizing trademark use will support a franchise relationship even if the mark is not part of the licensee's trade name – *e.g.*, Smith's Appliances, an authorized ABC service source.⁴¹ Permission to display a manufacturer's logo in dealing with customers satisfies this element.⁴²

³⁶ States adopting the marketing plan element: California, Illinois, Indiana, Maryland, North Dakota, Oregon, Rhode Island, and Wisconsin. Michigan and New York use variations of this element.

³⁷ States adopting the community of interest element: Hawaii, Minnesota, South Dakota, and Wisconsin.

³⁸ The New York Franchise Sales Law, NYGBL, Art. 33, Section 680-695, contains two alternative definitions of a franchise. One definition includes the franchise fee (discussed below) and marketing plan (discussed below), but does not require association with a franchisor's trademark. The other definition requires a franchise fee and the right to sell goods in substantial association with a mark.

³⁹ FTC Informal Staff Advisory Opinion to Permagraphics International, Inc., Bus. Franchise Guide (CCH) ¶ 6433 (Sept. 21, 1982).

⁴⁰ See, *e.g.*, Commissioner of Corporations Release 3-F Revised, June 22, 1994, entitled *When Does an Agreement Constitute a "Franchise"?*, reprinted at Bus. Franchise Guide (CCH) ¶ 5050.45 [hereinafter, Release 3-F]. Release 3-F dissects California's franchise definition. Regarding the trademark grant, it says, "Therefore, if a franchisee is granted the right to use the franchisor's symbol, that part of the franchise definition is satisfied even if the franchisee is not obligated to display the symbol."

As the pioneer state in regulating franchises, California's Release 3-F is often mentioned as a guidepost for jurisdictions with similarly worded statutes. See, *e.g.*, *In the Matter of KIS*, Bus. Franchise Guide (CCH) ¶ 8731 (December 24, 1986) (interpretive opinion by Wisconsin Securities Commissioner under Wisconsin law relying on Release 3-F and the similarity of the two franchise sales statutes).

Regarding the trademark grant, see also FTC Informal Staff Advisory Opinion to U.S. Marble, Inc., Bus. Franchise Guide (CCH) ¶ 6424 (Oct. 9, 1980), and *Metro All Snax, Inc. v. All Snax, Inc.* (D. Minn. 1996) (unpublished), Bus. Franchise Guide (CCH) ¶ 10,885 (Minnesota law).

⁴¹ See string of cases finding franchise relationships under New Jersey's law, including: *Lithuanian Commerce Corp. v. Sara Lee Hosiery*, 179 F.R.D. 450, 472 (D.N.J. 1998), Bus. Franchise Guide (CCH) ¶ 11,460; *Cassidy Podell Lynch, Inc. v. Snyder Gen. Corp.*, 944 F.2d 1131, 1139-40 (3d Cir. 1991), Bus. Franchise Guide (CCH) ¶ 9885 (while grant element existed, court found relationship was not a franchise because requisite community of interest was missing); *Neptune T.V. & Appliance Serv. Inc. v. Litton Microwave Cooking Prod.*, 462 A.2d 595 (N.J. 1983), Bus. Franchise Guide (CCH) ¶ 8023 (similar outcome as *Cassidy*). See also *American* (footnote continued on next page)

Despite the absence of an express grant authorizing trademark use, courts have found *de facto licenses* based on the parties' conduct. A *de facto license* may be established from the licensee's duty to use best efforts to promote the sale of branded products;⁴³ wear uniforms and otherwise add the licensor's logo or name on delivery vehicles or store windows;⁴⁴ complete special training and fulfill manufacturer warranty support locally;⁴⁵ sell uniquely configured products which consumers readily associate with a particular manufacturer;⁴⁶ follow detailed operating procedures, maintain facilities and equipment and perform services following manufacturer instructions,⁴⁷ and advertise its authorized dealer status locally.⁴⁸

Most states use the *substantial association* approach.⁴⁹ Under this approach, courts have found the trademark element satisfied when branded products account for a significant percent of the distributor's overall sales.⁵⁰ In *Wright-Moore Corp. v. Ricoh Corp.*,⁵¹ while the dealer was forbidden to use Ricoh's trademark as a business name, *substantial association* arose from the dealer's right to promote its status as an authorized Ricoh distributor and use of Ricoh-supplied advertising.

(footnote continued from previous page)

Business Interiors, Inc. v. Haworth, Inc. 790 F. 2d 1135, 1140 (8th Cir. 1986), Bus. Franchise Guide (CCH) ¶ 8642 (Missouri law, following *Neptune* and cases from other jurisdictions which all found the requisite grant element under different definitional models).

⁴² Release 3-F, *supra* note 40.

⁴³ See *Cassidy Podell Lynch*, *supra* note 41 at 1139.

⁴⁴ See *Cooper Distrib. Co., Inc. v. Amana Refrigeration, Inc.*, 63 F.3d 262, 272-73 (3d Cir. 1995), Bus. Franchise Guide (CCH) ¶ 10,743.

⁴⁵ *Cooper Distrib., Id.* at 272.

⁴⁶ See *Lobdell v. Sugar 'N Spice*, 33 Wn. App. 881, 890 (Wash. Ct. App. 1983), Bus. Franchise Guide (CCH) ¶ 7947 (Washington law).

⁴⁷ See *Cassidy Podell Lynch*, *supra* note 41. While *Cassidy* mentions this as evidence of a trademark license, it classically is associated with the marketing plan element. However, New Jersey follows the community of interest definitional model, not the marketing plan model, which may explain why the court mentions these factors as evidence of Cassidy's connection with the manufacturer's trademarks.

⁴⁸ See *Cooper Distrib.*, *supra* note 44; *Cassidy Podell Lynch*, *supra* note 41.

⁴⁹ E.g., California, Illinois, Indiana, Maryland, Michigan, New York, North Dakota, Rhode Island, Virginia, and Wisconsin.

⁵⁰ See *Master Abrasive Corp. v. Williams*, 469 N.E. 2d 1196, 1199 (Ind. Ct. App. 1984), Bus. Franchise Guide (CCH) ¶ 8248, *overruled on other grounds*, *Enservco, Inc. v. Indiana Sec. Div.*, 623 N.E. 2d 416 (Ind. 1993). But see *Hoosier Penn Oil Co. v. Ashland Oil Co.*, 934 F. 2d 882, 886 (7th Cir. 1991), Bus. Franchise Guide (CCH) ¶ 9834 (applying Indiana law, court found that motor oil distributor was not substantially associated with supplier's products which only accounted for 10% of the distributor's total sales. The supplier's brand was one of 20 motor oil brands that the distributor sold, the distributor's employees did not wear uniforms bearing the supplier's logo, and of the distributor's nine delivery trucks, only one bore the supplier's logo).

Since the franchise definition depends on the totality of circumstances, there is no universally recognized minimum percentage of branded product sales that qualifies as a *substantial association* with the supplier's trademark. The FTC Rule and a number of jurisdictions recognize a *fractional franchise* exemption, discussed in the text *infra*, that exempts multi-line distributorships from the franchise definition when sales of any one brand make up less than 20% of the distributor's total sales.

⁵¹ 908 F.2d 128 (7th Cir. 1990), Bus. Franchise Guide (CCH) ¶ 9665.

*Kim v. Servosnax, Inc.*⁵² shows how courts liberally apply remedial or protective statutes, like franchise laws, and stretch legal definitions to achieve desired results. Here, *substantial association* with the licensor's mark was found despite the fact the licensee, Kim, was contractually prohibited from using the Servo mark and never did. Kim owned and operated a cafeteria in a building complex pursuant to a contract between Servosnax and the building owner. Even though Kim's cafeteria customers never saw the Servo name displayed anywhere, Kim's business was a franchise because the building owner relied on the Servo name in contracting with Servosnax for the build-out and operation of a cafeteria in its space. The building owners qualified as customers of the Servo brand supporting the *substantial association* element, even if the licensee's ultimate retail customers were unaware of the association.

*Gentis v. Safeguard Business Systems*⁵³ also illustrates liberal judicial construction at work, expanding the franchise definition beyond conventional thinking. *Gentis* addresses a different aspect of the *grant* element in the California law, the right to engage in the business of *offering, selling or distributing* goods or services.⁵⁴ It found that sales representatives who

⁵² 10 Cal. App. 4th 1346 (Cal. Ct. App. 1992).

⁵³ 60 Cal. App. 4th 1294 (Cal. Ct. App. 1998).

⁵⁴ Crucial to understanding *Gentis* and harmonizing it, to the extent possible, with decisions under other state franchise laws is the fact that the grant element in California's definition speaks in terms of three possibilities, *offering, selling or distributing* goods or services. South Dakota's grant element, for example, speaks in terms of only two, *offering or distributing*, and Indiana's grant element speaks in terms of only one, *selling*. *Gentis* held that, even though Safeguard sales representatives lacked authority to enter into binding agreements to sell Safeguard products, they did enough to constitute *offering*, which, alone, was sufficient to bring the arrangement within California's definition. Alternatively, because the representatives did far more to ensure the sale and distribution of Safeguard services than just take orders for Safeguard and were an integral component of Safeguard's delivery system, overall, the grant element was satisfied. See Weiner, *Liberal Construction of Remedial Statutes: What is a Franchise?* 17 Franchise L.J. 115 (Spring 1998).

Notably, *Gentis* was distinguished in *East Wind Express, Inc. v. Airborne Freight Corp.*, 95 Wn. App. 98, 105 (Wash. Ct. App. 1999), *review denied*, 138 Wn. 2d 1023 (Wash. 1999), Bus. Franchise Guide (CCH) ¶ 11,617. *East Wind* held that an Airborne Freight licensee was not a franchise under Washington's franchise definition, which is identical to California's, because the licensee's involvement in the sale was confined to delivering Airborne's packages; the licensee did not market or sell delivery service to individual customers.

East Wind relied on *Lads Trucking v. Sears, Roebuck & Co.*, 666 F. Supp. 1418 (C.D. Cal. 1987), a pre-*Gentis* decision applying California law. *Lads Trucking* found that Sears' arrangement with independent trucking companies to deliver purchases to Sears' customers' homes was not a franchise under California law despite the carrier's right to use Sears' logos. The carrier did not participate in the contract of sale. The *Lads Trucking* decision was sharply criticized in *The Meaning of "Franchise," supra* note 31 at 1213-1215, 1219.

But see *Cawiezell v. Franklin Life Insurance Co.*, 2000 U.S. App. LEXIS 33766 (4th Cir. December 27, 2000) (not for publication) (Bus. Franchise Guide (CCH) ¶ 12,004 (discussed in Section IV.C below); and *George R. Darce Associates v. Beatrice Foods Co.*, 538 F. Supp 429 (DNJ 1981), Bus Franchise Guide (CCH) ¶ 7870 (a manufacturer's representative was not a franchisee because the limitation on the representative to act only as an agent for the solicitation of orders, without the authority to close a sale, did not establish the right to "offer," "sell" or "distribute" the manufacturer's products.).

See also *Accessories & Communication Systems Inc. v. Nortel Cala Inc.*, 85 F. Supp. 2d 95 (D. P. R. 2000), Bus. Franchise Guide (CCH) ¶ 11,816 (company providing installation services for manufacturer and marketer of telephone equipment was not a dealer under Puerto Rico Dealer's Act where installer did not market or sell
(footnote continued on next page)

solicited orders and provided local customer support were franchisees even though they never entered into binding agreements with customers to sell the supplier's goods or services or took title to, or delivered, the supplier's goods.

b. Marketing Plan Element

i. Significant Control or Significant Assistance

Significant control or significant assistance relates to the franchisor's involvement in the franchisee's *entire method of operation*.⁵⁵ The FTC Rule interpretive guides indicate that the following signify significant controls: reserving site approval, imposing design or appearance requirements, prescribing operating hours, establishing production methods⁵⁶ and standards, and dictating mandatory accounting practices. Significant assistance is supported by formal training programs, site location assistance, and operating advice such as by furnishing a detailed operating manual.

Just like the marketing plan definition discussed *infra*, significant promises of assistance, even if unfulfilled, will satisfy this element. However, just providing point-of-sales and advertising and media support, without more, will not satisfy the element.

The franchisee's *reliance* on the franchisor's experience determines if control or assistance is significant. The franchisee's general business experience, knowledge of the industry, relative financial risk in light of total business holdings, and the extent to which the controls or assistance go beyond normal industry practices each bear on the reliance factor.⁵⁷ For example, in a dispute over a management agreement between Meridien Hotels, Inc. and the Parker-Meridien Hotel, the FTC ruled that the relationship was not a franchise because the putative franchisee was an experienced hotel operator found not to have relied on the franchisor's assistance.⁵⁸

However, a license to operate mobile environmental laboratories offered only to experienced environmental consultants might still involve significant assistance, according to the

(footnote continued from previous page)

the manufacturer's products and had no additional contact with customers after completing installation services).

⁵⁵ See Interpretive Guides, *supra* note 13 at ¶ 6206.

⁵⁶ See, e.g., FTC Informal Staff Advisory Opinion issued to Dandi Products, Ltd., Bus. Franchise Guide (CCH) ¶ 6443 (May 3, 1984) (license granting right to use patented construction methods to manufacture, market, construct and sell certain buildings was a franchise). *But see* California Comm'r Op. 76/4F (December 27, 1976), 1976 Cal. Sec. LEXIS 1, and 77/1F (February 3, 1977), 1977 Cal. Sec. LEXIS 34 (license allowing independent parties to manufacture and sell patented materials were not franchises because each lacked the marketing plan element). *Accord* California Comm'r Op. 75/5F (July 2, 1975), 1975 Cal. Sec. LEXIS 18 (building materials dealership was not a franchise where supplier provided technical information about products, but no sales or marketing support. Opinion does not mention if products were patented or not.)

⁵⁷ See FTC Informal Staff Advisory Opinion 98-7, Bus. Franchise Guide (CCH) ¶ 6496 (December 10, 1998).

⁵⁸ See FTC Informal Staff Advisory Opinion 95-8, Bus. Franchise Guide (CCH) ¶ 6473 (Aug. 29, 1995).

FTC, if the licensor's technology was unique or sufficiently complex such that it required specialized training in order to be used correctly or efficiently.⁵⁹

ii. Marketing Plan

The marketing plan element is composed of distinct components which all must co-exist: a marketing plan - prescribed - in substantial part - by the grantor. Each component has been separately analyzed by judicial and administrative authority.⁶⁰

States differ in the degree of franchisor involvement in, or control over, a franchisee's daily business activities that are necessary to support a marketing plan. Some courts require significant control -- *e.g.*, confining sales to assigned territories, imposing sales quotas, approving sales personnel, establishing mandatory sales training, and supplying detailed instructions for customer selection and solicitation.⁶¹ Other courts, however, have found a marketing plan based on a promoter's recommendations, advice or suggestions even when there is no obligation on the franchisee's part to observe them -- *e.g.*, suggesting resale prices and discounts, providing sales equipment and advertising materials, recommending or screening advertising materials, and providing product catalogs.⁶²

A marketing plan will be found to exist based on a promoter's promise to provide one, even if the promoter fails to deliver on its promise.⁶³

The marketing plan element is the most difficult of the three elements to understand and structure around for at least three reasons. First, the word *prescribed* in the definitional element means something other than its conventional dictionary meaning. As explained in California's Release 3-F, prescribed does not mean mandatory.⁶⁴ A marketing plan may be prescribed by

⁵⁹ See FTC Informal Staff Advisory Opinion 98-4, Bus. Franchise Guide (CCH) ¶ 6493 (June 8, 1998). See also FTC Informal Staff Advisory Opinion 97-1, Bus. Franchise Guide (CCH) ¶ 6481 (discussed in Section IV.A below). In the 1997 opinion, the FTC emphasized that the fractional franchise exemption is not equivalent to a sophisticated investor exemption. Pending FTC Rule amendments would add a sophisticated investor exemption. FTC NPR *supra* note 16 at 57320-22. A sophisticated investor exemption would most likely protect the hotel management arrangement described in the text from being regulated as a franchise, at least in non-registration states.

⁶⁰ Release 3-F provides a comprehensive explanation of the individual components of the *marketing plan* element and identifies numerous provisions as indicia of a *marketing plan*. See *supra* note 40.

⁶¹ See *Master Abrasives*, *supra* note 50 at 1200; *Wright-Moore*, *supra* note 51 at 135.

⁶² See *To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift America*, *infra* note 162 at 994 (citing Illinois's statutory definition of marketing plan and observing, "From this language it is plain that advice about how to run the business need not be comprehensive in order to amount to a 'marketing plan'."). See also, *Blankenship v. Dialist Int'l Corp.*, 568 N.E.2d 503, 507 (Ill. Ct. App. 1991), Bus. Franchise Guide (CCH) ¶ 9808 (Illinois law).

⁶³ *Salkeld v. V.R. Business Brokers, Inc.*, 231 Ill. App. 3d 441 (Ill. Ct. App. 1992), Bus. Franchise Guide (CCH) ¶ 10,070 (Illinois law); *People v. Kline*, 110 Cal. App. 3d 587 (Cal. Ct. App. 1980), Bus. Franchise Guide (CCH) ¶ 7566 (California law).

⁶⁴ Release 3-F, *supra* note 40 at 7819.

implication when it is “outlined, suggested, recommended or otherwise originated by the franchisor,” but not obligatory.⁶⁵

Second, a marketing plan is to be judged by the co-existence of various indicia, but interpretative and judicial opinions have never identified a minimum number, or combination, of indicia that guarantee a marketing plan’s presence. The evaluation is entirely subjective, to be based not only on the parties’ contract, but on industry customs.⁶⁶ Consequently, the marketing plan element is both elastic and elusive.

Lastly, while early authority have tried to forge a distinction between production-type controls, which do not result in a marketing plan,⁶⁷ and marketing controls, which do, the distinction has never been well articulated. The problem lies in the fact that a marketing plan is not confined to controls or advice relating to advertising or marketing *per se*. It extends to detailed instructions and advice regarding operating techniques and skill training that make independent businesses appear as if they are centrally managed and follow uniform standards.⁶⁸

For example, no prescribed marketing plan was found in the relationship between a building materials supplier and experienced building contractors, who were given detailed technical instructions on the use of the supplier’s products and were confined to an exclusive sales territory. The supplier’s controls were focused on production techniques, not product marketing.⁶⁹

No marketing plan was found to exist in a health and medical equipment distributorship where the distributor retained absolute discretion over sales, marketing, merchandising and personnel and was required only to use its best efforts to sell the equipment.⁷⁰ Contrarily, a medical insurance service provider was found to have prescribed a marketing plan to regional representatives, who were full-time general insurance agents even though the agents spent minimal time on medical accounts and the prescribed sales plan only minimally affected their business activities.⁷¹

Consequently, structuring alternatives tend not to focus on eliminating the marketing plan element because of conflicting legal precedent and the element’s inherent imprecision.

⁶⁵ *Id.* See also, *Peter v. Stone Park Enterprises, LLC*, *supra* note 24 at 20 (citing *To-Am* as authority for the statement that, under Illinois law, a marketing plan need not be obligatory; a dealer must merely have *the right* to sell under the marketing plan).

⁶⁶ Release 3-F, *supra* note 40 at 7818-7820.

⁶⁷ See *supra* note 56 discussing California Commissioner Opinions.

⁶⁸ Release 3-F, *supra* note 40 at 7818.

⁶⁹ *Supra* note 56 (California Comm’r Op. 75/5F).

⁷⁰ *Bestest International, Inc. v. Futrex*, Bus. Franchise Guide (CCH) ¶ 11,915 (C.D. Cal. 2000) (court also found the trademark and fee elements lacking under California law, relying on Release 3-F among other authority).

⁷¹ See California Comm’r Op. 73/22F (May 21, 1973) 1973 Cal. Sec. LEXIS 128.

iii. Community of Interest

States differ in their approach to defining the community of interest element, although all follow common themes.⁷² A community of interest is no less elastic or elusive than the marketing plan alternative.

Wisconsin courts use a *totality of the circumstances* test that examines the franchisor's continuing financial interest and the parties' interdependence. In *Ziegler Co., Inc. v. Rexnord, Inc.*,⁷³ the Wisconsin Supreme Court advanced an elaborate community of interest test, focusing on the relative size of the dealer's investment, the longevity of the parties' relationship, the percentage of the dealer's time devoted to, and revenue derived from, the supplier's products, the extent of the dealer's identity with the supplier's trademarks, the parties' jointly developed sales goals, the dealer's fulfillment of warranty support, and similar factors.

New Jersey courts focus on the relationship's *sympiotic* character (*i.e.*, interdependence), measured largely by the relative size of the dealer's investment and whether that investment is firm specific and sunk.⁷⁴ This reflects the New Jersey courts' perception that a "true franchise arrangement" is characterized by "the consequent vulnerability of the alleged franchisee to an unconscionable loss of his tangible and intangible equities."⁷⁵

Minnesota courts use a rather nominal threshold, finding a community of interest present whenever parties derive fees from a common source, a standard that describes nearly every distributorship and licensing arrangement.⁷⁶

⁷² Indeed, the community of interest states have relied on each other's interpretations to support their own. *E.g.*, *Neptune*, *supra* note 41 at 161 relying on Washington, Hawaii and Wisconsin authority.

⁷³ 139 Wis. 2d 593, 407 N.W.2d 873 (Wis. 1987), Bus. Franchise Guide (CCH) ¶ 8882. The *Ziegler* community of interest test was followed recently by *Baldewein Co. v. Tri-Clover, Inc.*, 233 Wis. 2d 57, 66, 72-77 (Wis. 2000) (commenting that 'community of interest' has been the most vexing phase in the dealership definition for courts faced with applying this [Wisconsin] law." *Baldewein* used the *Ziegler* test to interpret the *situated in the state* language in Wisconsin's franchise law). The *Ziegler* test was also followed in *Edison Liquor Corp. v. United Distillers & Vintners North America, Inc.*, (unpublished) Bus. Franchise Guide (CCH) ¶ 11,957 (Wis. Cir. Ct. Sept. 6, 2000); *Beer Capitol Distributing, Inc. v. Guinness Bass Import Co.*, (unpublished), Bus. Franchise Guide (CCH) ¶ 11,914 (E.D. Wis. Aug. 4, 2000) (unpublished); *Cabinetree, Inc. v. Kraftmaid Cabinetry*, 914 F. Supp. 296 (*E.D. Wis.* 1996), Bus. Franchise Guide (CCH) ¶ 10,938; *Sales & Marketing Assos. V. Huffly Corp.*, 57 F. 3d 602, 606 (7th Cir. 1995), Bus. Franchise Guide (CCH) ¶ 10,707; and *Pollack v. Calimag*, 157 Wis. 2d 222, 458 N.W. 2d 591 (Wis. 1990), Bus. Franchise Guide (CCH) ¶ 9659. Each decision applied the *Ziegler* test, but found no community of interest present in the subject arrangement.

⁷⁴ See *Neptune*, *supra* note 41 at 165.

⁷⁵ See *Neptune*, *supra* note 41 at 165 (*Neptune's* authority to repair Litton microwave ovens did not give rise to a community of interest where Litton did not profit from *Neptune's* repair operations, *Neptune's* service reputation did not enhance Litton's reputation, and *Neptune* did not directly augment Litton's sales through its repair business).

⁷⁶ See *Metro All Snax*, *supra* note 40 (community of interest existed in a snack distributorship where third party manufacturers made payments to the supplier based on the size of the distributors' orders). See also *Martin Investors, Inc. v. Vander Bie*, 269 N.W. 2d 868, 874-75 (Minn. 1978) (community of interest found between a computer-service company that matched the needs of potential borrowers to potential lenders and a consultant who sold the system, when computer service company had a contractual right to 1% of the proceeds of loans the consultant placed).

c. Required Fee Element

The required fee element captures all sources of revenue paid by a franchisee to a franchisor for the distribution rights. While the element is deliberately expansive, encompassing lump sum, installment, fixed, fluctuating, up-front, and periodic payments for goods or services, however denominated, whether direct, indirect,⁷⁷ hidden,⁷⁸ or refundable,⁷⁹ several definitional limitations are worth noting.

First, the FTC Rule recognizes a minimum payment exemption, excusing payments of less than \$500 made anytime before or during the first six months of operations.⁸⁰ The FTC has advised that deferring collection of more than \$500 until after the end of the first six months of operations will avoid the required fee element even if the investor must sign a non-negotiable, secured promissory note (with no acceleration clause) at the relationship's inception.⁸¹ While the minimum payment exemption offers interesting structuring opportunities, it is not universally available.⁸² This is discussed in Section III.B.2.

Second, all jurisdictions exclude from the fee element payments which do not exceed the *bona fide* wholesale price of inventory, as long as there is no accompanying obligation to

⁷⁷ 815 ILL. COMP. STAT. § 705/3 (14) (West 1993 & Supp. 1996). Indirect payments constituting franchise fees have included charges for the cost of finding retail locations for the manufacturer's product racks and the costs of advertising (*Lobdell, supra* note 46); required purchases of trademarked motor oil, tires, batteries, and other products from the manufacturer or from approved suppliers (*Blanton v. Mobil Oil Corp.*, 721 F.2d 1207 (9th Cir. 1983)); and payments for employee training, on-line computer services, and required advertising, promotion and sales materials (*Tractor & Farm Supply v. Ford New Holland*, 898 F. Supp. 1198, 1204 (W.D. Ky. 1995)).

⁷⁸ See James R. Sims III and Mary Beth Trice, *The Inadvertent Franchise and How to Safeguard Against It*, 18 Franchise L.J. 54 (Fall 1998), and Sims and Trice, *Hidden Franchises*, ABA Forum on Franchising (Oct. 22-24, 1997), Tab 12 [hereinafter, *Hidden Franchises*].

⁷⁹ FTC Informal Staff Advisory Opinion 00-2 (January 24, 2000), Bus. Franchise Guide (CCH) ¶ 6506 (working capital deposit, while refundable at end of relationship less any operating expenses advanced by the grantor, was a franchise fee because it was entirely potentially at risk from the time it was paid).

⁸⁰ FTC Rule at § 436.2(a)(3)(iii), *supra* note 16.

⁸¹ FTC Informal Staff Advisory Opinion 98-3 (May 4, 1998), Bus. Franchise Guide (CCH) ¶ 6492 (but same result does not follow when note contains an acceleration clause).

⁸² A few states exclude annual payments below a minimum threshold from the franchise fee definition (*e.g.*, California, \$500 annually (increased in 2001 from \$100); Minnesota, \$100 annually; New York, \$500 annually, if sales materials of equal or greater value are received by the franchisee). Some states exclude minimum payments (*e.g.*, Illinois, \$500) from the franchise fee definition, without specifying an annual limit. In a state like Illinois, which (under one court's ruling) considers all payments during the life of the licensing relationship, there exists the possibility that years after the relationship is formed, it can be declared a franchise once license payments exceed the minimum threshold. Franchise status would relate back to the start of the relationship, not from the point in time when payments exceed the minimum payment threshold. See the discussion of the *To-Am* case in Section III and accompanying notes (franchise relationship existed under Illinois law once distributor paid the manufacturer over \$500 several years into the relationship).

purchase excessive quantities. To qualify, the payment must be for *goods* for which there is a ready market.⁸³ The *bona fide* wholesale price exclusion is discussed in Section III.B.1.

Third, only *required* payments count, not optional ones. This aspect of the definitional element is discussed in Section III.B.2.

Lastly, the payment must be made to the grantor, its affiliate, or for their benefit as the *quid pro quo* for the licensing or distribution rights.⁸⁴ There is some lingering confusion over whether ordinary business expenses paid to third parties qualify as a required fee.⁸⁵

While franchise fees are payments required to obtain distribution rights, confusion exists over whether they are confined to payments to the franchisor (or an affiliate, or for their benefit) or include payments to third parties. All jurisdictions which have considered the issue, except Indiana, take the former, narrower view.⁸⁶

⁸³ *Boat & Motor Mart v. Sea Ray Boats, Inc.*, 825 F.2d 1285 (9th Cir. 1987), Bus. Franchise Guide (CCH) ¶ 8846 (noting that California's *bona fide* wholesale price exemption is available only for purchases of goods, but law was ambiguous on the meaning of goods so court abstained from deciding if a franchise fee had been paid in the case). See also, *Flynn Beverage, Inc. v. Joseph E. Seagram & Sons, Inc.*, 815 F. Supp. 1174 (C.D. Ill. 1993), Bus. Franchise Guide (CCH) ¶ 10,237 (indirect franchise fee found where distributor was required to buy more than \$500 of new brands for which there was no established market).

But see Digital Equipment Corp. v. Uniq Digital Technologies, 73 F.3d 756 (7th Cir. 1996), Bus. Franchise Guide (CCH) ¶ 10,824 (duty to order inventory a year in advance was not a mandatory purchase requirement, but a requirement pertaining to the timing of orders).

⁸⁴ *Upper Midwest Sales v. Ecolab*, 577 N.W. 2d 236 (Minn. Ct. App. 1998), Bus. Franchise Guide (CCH) ¶ 11,948 (payment to licensor to acquire branch office business assets to start janitorial products distributorship was not a franchise fee under Minnesota law. Court found that payments were for assets themselves, not distributorship rights. Furthermore, subsequent agreement by distributor canceling territorial rights did not constitute payment of a franchise fee, which is limited to monetary payments, not other forms of legal consideration).

⁸⁵ Several cases hold that ordinary and necessary business expenses are not franchise fees. *In re The Matterhorn Group, Inc.*, *supra* note 28 at 32 (New York law); *Watkins & Pet Supplies v. Iams Co.*, 107 F. Supp. 2d 883, 891 (D. Ohio 1999) (ordinary business expenses are not franchise fees under Michigan law); *Siedare Associates, Inc. v. Amperex Sales Corp.*, Bus. Franchise Guide (CCH) ¶ 7732 (D. Minn. 1981) (unpublished) (Minnesota law; business expenses in conjunction with mandatory training are not indirect franchise fees); *Premier Wine & Spirits v. E. & J. Gallo Winery*, 644 F.Supp. 1431 (E.D. Cal. 1986), *aff'd*, 846 F.2d 537 (9th Cir. 1988), Bus. Franchise Guide (CCH) ¶ 9106 (South Dakota law; additional employee expenses to manage distributorship were not franchise fees); *OT Industries, Inc. v. OT-Tehdas Oy Santasalo-Sohlberg AB*, 346 N.W.2d 162, Bus. Franchise Guide (CCH) ¶ 8128 (Minn. 1984) (advertising expenses paid to third parties were not franchise fees under Minnesota law).

Peter v. Stone Park Enterprises, LLC, *supra* note 24, notes that Illinois specifically defines *indirect franchise fee* to exclude payments to the franchisor or its affiliate when the franchisee may purchase the same items from another source.

See also *Sports Racing Servs. v. Sports Car Club of Am.*, 131 F.3d 874, 891 (10th Cir. 1997) (payments to purchase predecessor's business were not franchise fees under Indiana law merely because franchisor approved the transaction where there was no evidence that any portion of the purchase price was paid to, or otherwise benefited, the franchisor, citing *Implement Serv., Inc. v. Tecumseh Prods. Co.*, 726 F. Supp. 1171, 1179 (S.D. Ind. 1989) (Indiana law).

⁸⁶ See discussion of *Wright-Moore v. Ricoh* and subsequent cases, *infra*, and notes 87 to 89.

The prevailing confusion can be traced to *Wright-Moore v. Ricoh*,⁸⁷ a Seventh Circuit decision interpreting Indiana’s franchise law. *Wright-Moore* indicated that payments to third parties could, under specific facts, constitute an indirect franchise fee when the distributor’s investment is “substantial and non-recoverable” (meaning the investment is sunk and has no market value).

Recently, *Best Distributing Co., Inc. v. Seyfert Foods, Inc.*,⁸⁸ an Indiana state court decision, claiming to follow *Wright-Moore*, held that various third party payments were *not* indirect fees because, instead of being made for “the right to conduct business,” the court said they had been made “in the course of doing business.” As most third party payments can be said to be made “in the course of doing business,” under *Best*’s rationale, they are never franchise fees. *Best* also sidestepped *Wright-Moore* by finding that the subject expenses were not required, and then by finding that they were recoverable. While *Best* purports to follow *Wright-Moore*, the decision certainly suggests otherwise.⁸⁹ It leaves *Wright-Moore* as the only authority to suggest that third party payments not made for the franchisor’s benefit can still qualify as a franchise fee.

3. *Exclusions and Exemptions From Coverage*

As noted, every jurisdiction has its own mix of definitional exclusions and exemptions, offering a variety of structuring opportunities. While some are common to most, or all, jurisdictions (*e.g.*, transfers by franchisees and the *bona fide* wholesale price exclusion), others may be unique to the jurisdiction, reflecting local lobbying efforts (*e.g.*, Minnesota’s exemption of burglar alarm franchises).⁹⁰

Appendix A provides a chart showing the most popular exclusions and exemptions. The following briefly identifies the more significant exclusions and exemptions. These references are not an exhaustive list of all potentially available exclusions and exemptions and individual statutes must always be checked.

FTC Rule: Fractional franchise;⁹¹ single trademark license;⁹² minimum payments;⁹³ leased departments; purely oral agreements; employment relationships; general partnerships;⁹⁴ agricultural and retailer cooperatives; and certification and testing services, like the Good Housekeeping Seal.

⁸⁷ *Supra* note 51.

⁸⁸ 714 NE.2d 1196 (Ind. Ct. App. 1999), *Bus. Franchise Guide* (CCH) ¶ 11,669.

⁸⁹ As a federal district court interpreting Indiana law, *Wright-Moore* is not binding on Indiana state courts. *Best*, a state court case, however, claims to follow *Wright-Moore*.

⁹⁰ MN ST §80C.30.

⁹¹ Discussed in Section III.C.1 of the text and accompanying notes.

⁹² Discussed in Section III.C.2 of the text and accompanying notes.

⁹³ Discussed in Section III.B.2 of the text and accompanying notes.

⁹⁴ Discussed in Section III.A of the text and accompanying notes.

State laws: The “large/experienced” franchisor or *blue chip* exemption for franchisors meeting specific thresholds for net worth and network size;⁹⁵ the renewal or extension of an existing franchise without material changes; transfers by franchisees for their own account; isolated sales; minimum payments;⁹⁶ fractional franchises; and sophisticated franchisees.⁹⁷ Additionally statutes give regulators authority to grant ad hoc exemptions to transactions which, in the regulator’s judgment do not require regulation.⁹⁸

From this patchwork quilt of franchise statutes, regulations, exemptions, exclusions, judicial decisions and interpretive opinions, businesses must analyze whether a proposed license or distribution arrangement is a franchise, or whether the arrangement may be structured to avoid the franchise label.

II. THE REGULATION OF BUSINESS OPPORTUNITIES AND SALES REPRESENTATIVES

If a commercial arrangement is not a *franchise* under federal or state laws, or even if it is structured intentionally to avoid a definitional element, there remain other regulatory schemes that may ensnare an unsuspecting entrepreneur.

Two such schemes, business opportunity laws and sales representative laws, were, like franchise laws, originally drafted with the goal of protecting the archetype mom and pop small business owner. In writing these laws, legislators were not always careful to avoid overlap with franchise laws, nor did they necessarily give special thought to the broad array of commercial arrangements that might be covered. Consequently, business ventures that qualify as franchises or involve sophisticated investors may still find themselves being regulated under business opportunity laws and occasionally under sales representative laws as well.

A. Business Opportunities

Laws regulating the sale of business opportunity ventures exist in almost half of the states and at the federal level, through the FTC Rule. Nearly all of the franchise registration states also regulate the sale of business opportunities. While the federal scheme, for now, regulates both franchises and business opportunities identically in the same regulation (the FTC Rule), most of the franchise registration states regulate business opportunity sales under a separate statute. Some state laws use the term *seller-assisted marketing plans* to refer to these arrangements instead of the more conventional *business opportunity* (the term that the FTC Rule uses), but there is no real conceptual or practical difference between *seller-assisted marketing plans* and *business opportunities*.

⁹⁵ Discussed in Section III.C.3 of the text and accompanying notes.

⁹⁶ Discussed in Section III.B.2 of the text and accompanying notes.

⁹⁷ Discussed in Section III.C.4 of the text and accompanying notes.

⁹⁸ See, e.g., Cal. Corp. Code § 31100.

Federal and state laws broadly define these arrangements with sweeping language. Consequently, absent an express exemption, business opportunity and seller-assisted marketing plan sales laws potentially cover traditional franchises as well as non-franchise dealership programs.

1. *FTC Rule - Business Opportunity Sales*

The FTC Rule essentially treats “business opportunities” as a separate type of franchise – different from package or product franchises. Specifically, the FTC Rule governs business arrangements in which:

- (a) the seller (or franchisor), or a person affiliated with the seller, supplies the buyer (or franchisee) with goods or services,
- (b) the seller assists the buyer in securing outlets, accounts, or locations for the buyer, or provides the buyer with display racks, and
- (c) the buyer (franchisee) is required to make a \$500 payment during the first six months of operations.⁹⁹

A key distinction between the FTC Rule’s approach to product and package franchises on the one hand, and business opportunity ventures on the other, is that the Rule is specific in identifying the kind of assistance required for a relationship to be a business opportunity, but non-exacting in describing the controls or assistance required for a franchise. The Rule specifies that a business opportunity seller must offer to secure outlets, accounts or locations for the buyer or provide the buyer with product sales displays. However, the FTC has consistently taken an expansive view on what qualifies as location and account assistance.¹⁰⁰ Further, the Rule’s business opportunity definition does not require that the buyer use, or substantially associate its business with, the seller’s trademark. Through the business opportunity definition, the Rule regulates as franchises ordinary distributorships and rack jobbing, video game, and vending machine routes.

If a business opportunity is covered by the FTC Rule, then the disclosure obligations of the FTC Rule (discussed in Part I.B. above) apply to the offer and sale of the business opportunity venture. As noted, the FTC expects to sever business opportunity ventures from the Rule and regulate them separately.¹⁰¹ The recently released FTC and GAO reports assessing FTC Rule enforcement practices¹⁰² indicate that the FTC’s enforcement efforts are dominated by complaints involving business opportunity sellers, and the FTC has spent much less enforcement time on package or product (*i.e.*, traditional) franchisors.

⁹⁹ *Supra* note 16, at § 436.2(a).

¹⁰⁰ FTC Informal Staff Advisory Opinion 98-1 (January 6, 1998), Bus. Franchise Guide (CCH) ¶ 6490; FTC Informal Staff Advisory Opinion 95-10 (December 8, 1995), Bus. Franchise Guide (CCH) ¶ 6475; FTC Informal Staff Advisory Opinion 93-8 (July 22, 1993), Bus. Franchise Guide (CCH) ¶ 6452.

¹⁰¹ FTC NPR *supra* note 18.

¹⁰² See discussion at note 17 *supra*.

2. *State Business Opportunity or Seller-Assisted Marketing Plan Laws*

There are 24 states with laws which pertain to the offer and sale of business opportunities or seller-assisted marketing plans.¹⁰³ These states are:

California	Louisiana	Ohio
Connecticut	Maine	Oklahoma
Florida	Maryland	South Carolina
Georgia	Michigan	South Dakota
Illinois	Minnesota	Texas
Indiana	Nebraska	Utah
Iowa	New Hampshire	Virginia
Kentucky	North Carolina	Washington

While the definitional approaches vary from state to state, a general composite definition¹⁰⁴ of a “business opportunity” is as follows:

1. A seller furnishes goods or services;
2. for a payment of \$500 or more;¹⁰⁵
3. to enable the buyer to start a business; and
4. the seller represents to the buyer any one or more of the following:
 - (a) the business arrangement may, will, or can earn the buyer more income than the cost of the program;
 - (b) the seller will buy back all or part of the buyer's output;

¹⁰³ Cal. Civ. Code § 1812.201 to .221 (Deering 2001); Conn. Gen. Stat. § 36b-60 to –80 (2001); Fla. Stat. ch. 559.80 to -.815 (2000); Ga. Code Ann. § 10-1-410 to 1-417 (2000); Ind. Code Ann. § 24-5-8-1 to –21 (Michie 2000); 815 Ill. Comp. Stat. 602/5-1 to /99-1 (2001); Iowa Code § 523B.1 to .11 (2001); Ky. Rev. Stat. Ann. § 367.801 to .819, 367.990 (Michie 2001); La. Rev. Stat. § 51:1821 to :1824 (2000); Me. Rev. Stat. tit. 32, § 4691 to 4700-B (2000); Md. Code Ann., Bus. Reg. § 14-101 to –129 (2000); Mich. Comp. Laws § 445.902 and .903b (2001); Minn. Stat. § 80C.01 to .22 (2000); Neb. Rev. Stat. § 59-1701 to –1761 (2001); N.H. Rev. Stat. Ann. § 358-E:1 to E:6 (2001); N.C. Gen. Stat. § 66-94 to –100 (2000); Ohio Rev. Code Ann. § 1334.01 to .99 (Andersen 2001); Okla. Stat. tit. 71, § 801 to 827 (2000); S.C. Code Ann. § 39-57-10 to –80 (2000); S.D. Codified Laws § 37-25A-1 to –54 (2001); Tex. Bus. & Com. Code Ann. § 41.001 to .010 (2000); Utah Code Ann. § 13-15-1 to –7 (2001); Va. Code Ann. § 59.1-262 to 269 (2001); Wash. Rev. Code § 19.110.010 to .930 (2001).

¹⁰⁴ Attached as Appendix B is a chart that sets forth the definitional elements of a business opportunity under each state law.

¹⁰⁵ Some states have a lower fee threshold. See Appendix B.

- (c) the seller will find, or help find, locations for racks, vending machines, etc.;
- (d) if the buyer becomes dissatisfied with the deal, the seller will refund the initial payment or buy back the deal;
- (e) for a fee, the seller will provide a marketing or operating plan;
- (f) a market exists for the products to be sold by the business opportunity;
- (g) the seller will sell, lease or distribute products; or
- (h) the seller will pay the buyer the difference between the buyer's initial payment and actual investment earnings.

If any one of the enumerated representations is made (and assuming all other statutory conditions are met and no basis for an exemption exists¹⁰⁶), the arrangement qualifies as a business opportunity under state law. (Like franchises, the arrangement is subject to dual regulation under the FTC Rule if it meets the federal business opportunity venture definition.)

The 24 states noted above have pre-sale regulatory schemes that exhibit, to a greater or lesser extent similarities to the franchise registration and disclosure laws.¹⁰⁷ Generally, if an enterprise is subject to a business opportunity law, the seller must prepare a disclosure document, file and register that disclosure document with the state agency, and receive approval from the state agency, prior to the offer of a business opportunity to a purchaser. In addition, some states condition the registration on the seller incorporating specific language in the agreement. A number of states also require the business opportunity seller to post a surety bond (often with a minimum amount of \$50,000 to \$75,000) to cover any losses incurred by the purchasers which may result from a seller's violation of the law.

3. *Interpreting and Complying with the Statutes*

In defining their target, there exists greater variation among state business opportunity laws than among state franchise laws. Accordingly, it is difficult to generalize about the interpretation and application of business opportunity statutes and certainly short-sighted to do so in a counseling context. Nonetheless, several themes are worth noting.

¹⁰⁶ See discussion below at Part II. A.4, and Appendix C, which is a chart of various exemptions or exclusions from the business opportunity laws.

¹⁰⁷ In addition, three jurisdictions, Alabama, the District of Columbia, and Tennessee, make reference to business opportunities or seller-assisted marketing plans in their consumer protection or unfair and deceptive trade practices statutes. Alabama Deceptive Trade Practices Act, Ala. Code § 8-19-1 to -15 (2001); District of Columbia Consumer Protection Procedures Law, D.C. Code § 28-3901 to 28-3908 (1981); and Tennessee Consumer Protection Act, Tenn. Code Ann, §§ 48-18-101 to 47-18-117. Alabama's Deceptive Trade Practices Act, for example, declares that certain deceptive acts or practices are unlawful in connection with any "Seller assisted marketing plan." Ala. Code § 8-19-5(20).

a. Misrepresentation and Prohibited Practices

Business opportunity laws contain anti-fraud provisions comparable to those found in franchise sales statutes. Both types of laws make it unlawful for a seller to misrepresent, either by misstatement or omission, information material to the investment decision or to engage in any false, fraudulent, misleading, or deceptive act. Business opportunity laws tend to be more specific in their proscriptions, forbidding particular practices in the sale of goods to business opportunity purchasers. For example, some laws forbid sellers to take money for goods which will not be delivered within two weeks, to require a down payment on goods which exceed 20% of the purchase price, or to fail to deliver goods in a timely manner.¹⁰⁸

b. Representations and Guarantees

While most franchisors and manufacturers do not guarantee sales, earnings or profits to franchisees or dealers, and many do not offer to refund or repurchase inventory if the franchisee or dealer is not satisfied with the relationship, business opportunity laws may be triggered by something less than express representations or guarantees. Consequently, business opportunity laws may ensnare unsuspecting business venture sellers, including franchisors and manufacturers.¹⁰⁹

For example, eight states (California, Indiana, Iowa, Kentucky, Michigan, Nebraska, Ohio and Texas) require the seller only to represent that earnings from the business opportunity venture will *likely* exceed the buyer's initial investment (a representation that is considerably less firm than a guaranty). Another 14 states require the seller to make some kind of income guaranty in order to trigger statutory coverage (Connecticut, Florida, Illinois, Louisiana, Maine, Maryland, Minnesota, North Carolina, Oklahoma, South Carolina, South Dakota, Utah, Virginia, and Washington). However, several courts and administrative agencies have found the guaranty requirement satisfied by the seller's representations about *potential* profits (again, something less than a firm promise).

For example, in *Martin v. Pilot Industries*,¹¹⁰ the court ruled that the seller's representations in advertising about *projected* earnings from the business opportunity was an *income guaranty* bringing the seller under the purview of the North Carolina Business Opportunity Sales Law even though the seller expressly disclaimed all representations outside of the contract. Also, the State of Connecticut has taken the position that assurances of profit may arise by implication.¹¹¹ Therefore, unless an arrangement qualifies for an express exemption, unwary sellers, franchisors and manufacturers may find themselves subject to a number of

¹⁰⁸ Cal. Civ. Code § 1812.210 (Deering 2001); Ind. Code Ann. § 24-5-8-12 (Michie 2000).

¹⁰⁹ An argument can be made that a contract provision allowing a franchisee or distributor to cancel or terminate the contract for any reason, at its option, and receive a full or partial refund of initial payments, qualifies as a refund representation under a state business opportunity law. Limiting the right to cancel to certain events, *e.g.*, the failure to find a suitable site within a specific timeframe, helps to defeat this argument.

¹¹⁰ 632 F.2d 271 (4th Cir. 1980).

¹¹¹ *Interpretive Opinion of Connecticut Banking Commissioner*, Bus. Franchise Guide (CCH) ¶7699 (1981).

business opportunity laws as courts and enforcement agencies liberally hold certain conduct to be the equivalent of an express representation sufficient to invoke a business opportunity statute.

c. Fees

Like the franchise investment laws, the business opportunity laws may apply due to a relatively small initial payment or investment on the part of the buyer. Most of the laws provide that payments made during the first six months of operation will be considered in calculating whether the minimum fee threshold is satisfied. The initial payment required under the laws may be met by an initial franchise fee, monthly royalty fees, or even the payment for goods or services. This payment requirement includes payments made for purchases of products for resale, for training, and for advertising materials or marketing support. (Unlike the franchise laws, there is no exception for payment for inventory at *bona fide* wholesale prices for resale.¹¹²) A prevalent (but not universal) exception to the definition of initial fee or initial payment is that the cost of a sales demonstration kit is not considered part of the fee or initial payment.¹¹³

As noted in the composite definition above, if a buyer makes a payment of \$500 or more, the arrangement will fall within the definition of a business opportunity. The minimum payment threshold, however, also varies from state to state.¹¹⁴

d. Bonding Requirements

One element of the business opportunity laws which is different from the franchise investment laws is the requirement that certain business opportunity sellers post a surety bond or establish a trust account in favor of the state for the benefit of any person who is damaged by a violation of the law. The bonding requirements appear in 19 business opportunity laws, and the requirement is often applicable if the seller makes representations regarding the seller's obligations to refund the purchase price of the business opportunity or to repurchase inventory.¹¹⁵

e. Registration and Disclosure

If a business arrangement is subject to the state business opportunity laws, the seller must (under most state laws) provide a disclosure document to the prospective purchaser prior to the purchaser's execution of a contract or payment of any monies to the seller. Generally, a seller

¹¹² See discussion of *bona fide* wholesale price exception at Section III.B.1, below.

¹¹³ Fla. Stat. ch. 559.801 (2000); Ind. Code Ann. § 24-5-8-1 (Michie 2000); Md. Code Ann., Bus. Reg. § 14-104 (2000).

¹¹⁴ Fourteen states require buyers to make a minimum payment of \$500 (California, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Nebraska, Ohio, Oklahoma, Texas, and Virginia). In the remaining states, the minimum payment is less than \$500. California specifies that the buyer's initial payment must exceed \$500 (including cash and deferred obligations), but its initial cash payment must be under \$50,000. See Appendix B.

¹¹⁵ Contrast this with state franchise laws, many of which include provisions under which the franchise administrator has discretion to request a surety bond, an escrow of initial fees, or a defense of fees, if the financial condition of the franchisor is not sufficiently strong.

may use the franchise offering circular prepared for use in selling franchises, with certain state-specific modifications to the disclosure document, and/or to the agreement. Also, many states require business opportunity sellers to register the offering with the state prior to selling the business opportunity in the state.

4. *Exclusions or Exemptions*

Despite the wide reach of these laws, there are a number of exemptions or exclusions from the state business opportunity laws which may be applicable to many franchisors and other non-franchised business sellers. Some of these exemptions or exclusions include (i) compliance with the FTC Rule, or with the applicable state franchise investment law; (ii) the sale of a marketing plan in conjunction with the licensing of a registered mark; (iii) sales by *blue chip* sellers meeting minimum net worth requirements; and (iv) sales made to existing businesses (e.g., “conversion” franchises). There are other exemptions which should be examined on a state-by-state basis. See Appendix C.

a. Compliance With Franchise Laws

A business opportunity seller that complies with the FTC Rule or state franchise investment laws will be exempt from the business opportunity law in the following 17 states: California, Florida, Illinois, Indiana, Iowa, Kentucky, Maryland, Michigan, Minnesota, Nebraska, Ohio, Oklahoma, South Dakota, Texas, Utah (but only if certain representations regarding “repurchase” rights and earnings potential are not made), Virginia, and Washington. Florida, Kentucky, Nebraska, Texas, and Utah also require the filing of an exemption notice or exemption statement, and the payment of a fee, to secure this exemption.

b. Trademark and Marketing Plan

While most sellers do not guarantee their investor’s profits, promise to refund or repurchase inventory from unsatisfied investors, or knowingly make any of the other triggering representations described in the composite definition summarized above, most sellers, however, generally grant the right to use a distinct marketing plan in operating a business associated with the seller’s trademarks. The business opportunity laws of 15 states (Connecticut, Florida, Georgia, Illinois, Iowa, Louisiana, Maine, Maryland, Michigan, North Carolina, Oklahoma, South Carolina, South Dakota, Utah, and Washington) expressly exempt arrangements in which the seller either sells or licenses a marketing plan in conjunction with licensing the use of the seller’s *registered* trademark or service mark. Most business format franchisors qualify for this exemption. The Connecticut, Iowa, Maine, Michigan, and North Carolina laws each specify that the subject trademark must be *federally* registered, and Maryland, Oklahoma, and South Dakota go further by requiring that the trademark be *federally* registered *and* that the seller’s net worth exceed \$1 million. See Appendix B.

c. Large Net Worth

Like their franchise investment law cousins, the business opportunity laws in nine states (Georgia, Illinois, Indiana, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, and

Texas) have exemptions for sales by business opportunity sellers with a large net worth (referred to in Section I.C.3 above and Section III.C.3 below, as the “large/experienced franchisor” or “blue chip” exemption). The minimum net worth requirement varies from \$1 million (Illinois, Oklahoma and South Dakota) to \$25 million (Texas). Unlike many franchise laws, however, to qualify for the exemption, the seller need not demonstrate a significant operating history (*e.g.*, five years with 25 outlets), but may have to satisfy other requirements.

d. Sales to Existing Businesses

Most state business opportunity laws pertain to the offer of a business opportunity in connection with a purchaser *starting* a business, and will not apply to a business opportunity purchased in connection with the *continuation* or *maintenance* of an existing business. The laws in four states (California, Indiana, Nebraska, Ohio) apply to business opportunities purchased in connection with *starting* or *maintaining* a business. To the extent a franchisor or manufacturer offers franchises or distributorships for “conversion” units, or offers its system to existing operators, the business opportunity laws will likely not be applicable, except with respect to those four states.¹¹⁶

5. Penalties

The failure to comply with the business opportunity laws would subject the seller to a variety of penalties, which vary from state to state, including damages (which may include a recovery against the posted bond); punitive and/or treble damages; attorney's fees; rescission and/or restitution; state civil and/or administrative action; and state criminal action.

6. Summary

The lesson to draw from the foregoing synopsis of the business opportunity and seller-assisted marketing plan laws is that a wide range of distributor businesses and other business arrangements may be subject to these laws. Moreover, navigating away from the scope of one type of state law may steer the arrangement into another type of law or the franchise laws (under the FTC Rule or a state franchise investment law). Prior to offering franchises, distributorships, or other business opportunities in one of these 24 states, each state law should be reviewed carefully: (a) to determine if the law is applicable to the business, and/or if an exemption or exclusion is available, and (b) to ascertain the specific requirements necessary to comply with the law (*e.g.*, registration, disclosure, and posting a bond) or an exemption. Also, when developing or restructuring a sales, marketing, distribution, license, or franchise program, companies often seek to structure the arrangement to avoid the franchise laws. Counsel providing advice to companies that are considering such plans should also be cognizant of the business opportunities laws. Arrangements and business ventures that may avoid the franchise laws may nonetheless qualify as business opportunities, subjecting them to contractual, disclosure and registration requirements that may be similar to, or may be more burdensome and less consistent than, the franchise law requirements.

¹¹⁶ See *Eye Associates, P.C. v. IncomRx Systems Limited Partnership*, 912 F.2d 23 (2d Cir. 1990); and *Bunting v. Perdue, Inc.*, 611 F. Supp. 682 (E.D. N.C. 1985).

B. Sales Representatives

Thirty-five states and Puerto Rico regulate the business relationship between a manufacturer or distributor and the sales representatives that promote the sale of the manufacturer's products.¹¹⁷ The fundamental goal of sales representative laws is to ensure that the sales representatives are compensated properly in accordance with their written contracts, and that they are paid in a timely and fair manner. While the sales representative laws do not contain registration and disclosure obligations as do the franchise and business opportunity laws, these laws permit the recovery of actual damages, double or treble damages, and attorneys' fees as a remedy for violations of these laws.

I. Applicability to "Sales Representatives" and "Principals"

Generally, the sales representative laws define a "sales representative" as a person who contracts with a "principal" to solicit wholesale orders, and who is compensated in whole or in part by commission.¹¹⁸ The laws generally are not applicable to sales representatives who place orders for their own account, or otherwise sell directly to retail accounts. Examples of these laws are found in Illinois, Kentucky, Ohio, Pennsylvania and South Carolina.¹¹⁹ Some of the statutes expressly cover only sales representatives who solicit for wholesale orders only.¹²⁰ Several states expressly exclude employees from coverage under these laws (Illinois, Kansas, Maryland,

¹¹⁷ Ala. Code § 8-24-1 to -5 (1996); Ariz. Rev. Stat. Ann. § 44-1798 to 1798.03 (1996); Ark. Code Ann. § 4-70-301 to -306 (Michie 1995); Cal. Lab. Code § 2751 to 2752 (Deering 1996); Colo. Rev. Stat. § 12-66-101 to -104 (1996); Fla. Stat. § 686.201 (1996); Ga. Code Ann. § 10-1-700 to -704 (1996); Ill. Rev. Stat. Ch. 820 para. 120/0.01 to 120/3 (1996); Ind. Code § 24-4-7-1 to -6 (1996); Iowa Code § 91A.13 (1996); Kansas Stat. Ann. § 44-341 to -347 (1996); Ky. Rev. Stat. Ann. § 371.370 to .385 (Michie 1996); La. Rev. Stat. Ann. § 51:441 to 445 (West 1997); Me. Rev. Stat. Ann. tit. 10 § 1341 to 1344 (West 1996); Md. Code Ann., Lab. & Empl. § 3-601 to -607 (1996); Mass. Gen. L. ch. 104, § 7 to 9 (1996); Mich. Comp. Laws § 600.2961 (1996); Minn. Stat. § 181.145 and § 325E.37 (1996); Miss. Code Ann. § 75-87-1 to -7 (1996); Mo. Rev. Stat. § 407.911 to .915 (1996); Neb. Rev. Stat. § 48-1229 to -1232 (1996); N.H. Rev. Stat. Ann. § 339-E:1 to -E:6 (1996); N.J. Rev. Stat. § 2A:61A-1 to 61A-7 (1996); N.Y. Lab. Law § 191-a to 198-a (McKinney 1997); N.C. Gen. Stat. § 66-190 to -193 (1996); Ohio Rev. Code Ann. § 1335.11 (Anderson 1997); Okla. Stat. tit. 15, § 675 to 679 (1996); Or. Rev. Stat. § 646.878 (1996); Pa. Cons. Stat. § 1471 to 1478 (1996); P.R. Laws Ann. tit. 10, § 279 to 279h (1992); S.C. Code Ann. § 39-65-10 to -80 (Law. Co-op. 1996); Tenn. Code Ann. § 47-50-114 (1996); Tex. Bus. & Com. Code Ann. § 35.01 to .86 (West 1997); Va. Code Ann. § 59.1-455 to -459 (Michie 1996); Wash. Rev. Code § 49.48.150 to .190 (1996); Wis. Stat. § 134.93 (2000).

¹¹⁸ See, e.g., Wash. Rev. Code § 49.48.150 (2001).

¹¹⁹ Ill. Rev. Stat. Ch. 820 para. 120/01 (1996); Ky. Rev. Stat. Ann. § 371.370 (Michie 1996); Ohio Rev. Code Ann. § 1335.11 (Anderson 1997); Pa. Cons. Stat. § 1471 (1996); S.C. Code Ann. § 39-65-10 (Law. Co-op. 1996).

¹²⁰ Mass. Gen. L. ch. 104, § 7 (1996); Tenn. Code Ann. § 47-50-114.

Massachusetts, Minnesota, New York, Ohio and Pennsylvania),¹²¹ and door-to-door salespersons (Kansas and Mississippi).¹²²

Most of the sales representative laws were enacted out of a concern that the principals would not honor their commitments to their representatives. The term “principal” is broadly defined and applies to any person who “manufactures, produces, imports, or distributes a product for sale to customers who purchase the product for resale; uses a sales representative to solicit orders for the product; and compensates the sales representative in whole or in part by commission.”¹²³ Interestingly, a number of sales representative laws were written with the fear that out-of-state manufacturers or suppliers, as opposed to in-state suppliers, would be more likely to “stiff” the local sales representative or otherwise act unfairly or contrary to the contract. Therefore, at one time, 12 state sales representative laws applied only to principals that did not have a permanent or fixed place of business in the state.¹²⁴ Recently, the application of the North Carolina law only to out-of-state principals was struck down as unconstitutional as a violation of the Commerce Clause of the United States Constitution.¹²⁵ Similar provisions have been found unconstitutional in other states, including Pennsylvania, Ohio, Florida, Texas, and Kentucky,¹²⁶ or have been repealed in some states (*e.g.*, Louisiana¹²⁷).

2. *Written Contracts; Post-Termination Commissions*

The sales representative laws generally require a written contract between a principal and the sales representative. The contract must specify the method by which the commissions are calculated and paid. The sales representative laws also specify certain requirements for payment of commissions upon termination of the relationship ranging from five days to 45 days (if not otherwise specified in the contract). Most statutes, however, require that the final payment be made 30 days after termination.

In an effort to protect in-state sales representatives from the burden of pursuing an out-of-state principal to enforce the law, some laws provide that any contract provision that attempts to establish venue outside of the sales representative’s state are null and void, against public policy, and unenforceable. Some statutes also include a provision that subjects a non-resident principal

¹²¹ Ill. Rev. Stat. Ch. 820 para. 120/0.01 to 120/3 (1996); Kansas Stat. Ann. § 44-341 to –347 (1996); Md. Code Ann., Lab. & Empl. § 3-601 to –607 (1996); Mass. Gen. L. ch. 104, § 7 to 9 (1996); Minn. Stat. § 181.145 and § 325E.37 (1996); N.Y. Lab. Law § 191-a to 198-a (McKinney 1997); Ohio Rev. Code Ann. § 1335.11 (Anderson 1997); Pa. Cons. Stat. § 1471 to 1478 (1996).

¹²² Kansas Stat. Ann. § 44-341 to –347 (1996); Miss. Code Ann. § 75-87-1 to –7 (1996).

¹²³ La. Rev. Stat. Ann. §441(2).

¹²⁴ *See, e.g.*, Me. Rev. Stat. Ann. tit. 10 § 1341 to 1344 (West 1996); Or. Rev. Stat. § 646.878 (1996).

¹²⁵ *M-Squared, Inc. v. International Rectifier, Inc.*, Bus Franchise Guide (CCH) §12,059 (E.D. N.C. 2000) (unpublished).

¹²⁶ *See Harris v. Hartz & Co., Inc.*, 1996 WL 325547 (E.D. Pa. 1996); *Johnson, MacDonald & Assoc. v. Webster Plastics*, 856 F. Supp. 1249, 1253 (S.D. Ohio 1994); *Rosenfeld v. Lu*, 766 F. Supp. 1131, 1142 (S.D. Fla. 1991); *John Havlir & Assoc., Inc. v. Tacoa, Inc.*, 810 F. Supp. 752, 759 (N.D. Tex. 1993); *Cecil v. Duck Head Apparel Co., Inc.*, 895 F. Supp. 155, 158 (W.D. Ky. 1995).

¹²⁷ La. Rev. Stat. Ann. § 51:441 (2000); repeal, Laws of 1995, Act No. 48.

who enters into a contract with an in-state sales representative to be considered “doing business” for the purposes of exercising personal jurisdiction over the principal.¹²⁸

3. Remedies

The principal remedy under most of the sales representative laws is to provide a sales representative the timely payment of his/her/its commissions following termination of the relationship. If the commissions are not paid following termination of the contract, the laws permit an action for damages, as well as an award of attorneys’ fees and court costs. Many statutes also contain provisions for the award of double or treble damages.

4. Summary

Sales representative laws often do not come into play in analyzing business relationships or franchises. These laws are designed to protect a sales representative who promotes the products of others, but who is reliant on the supplier—not the end-user or customer—for his/her/its compensation.. While these laws seem relatively benign, particularly if the supplier simply complies with its contractual obligations, a manufacturer or supplier in today’s economy who is seeking new distribution channels should remain mindful of these laws.

III. STRUCTURING TO AVOID A FRANCHISE

Companies that distribute products or services through independent operators often attempt to restructure the relationship, or choose alternative relationship models, in an effort to avoid the real or perceived burdens of being deemed a franchisor. These potential burdens may include the perception (or reality) of the expense and legal entanglement of having to comply with franchise sales laws; possible impediments to system expansion which franchise sales laws may impose; public disclosure of financial statements; contractual limitations imposed by franchise relationship laws, including venue restrictions, and loss of flexibility due to restrictions on termination and non-renewal; a public image of franchising that sometimes may be negative or unflattering; and exposure to inventive liability theories premised on the existence of a franchise relationship.

The goal of these avoidance techniques is to create a commercial arrangement that omits one of the definitional elements. Since jurisdictions vary in their definitional schemes, a restructured arrangement may succeed in avoiding regulation in some, but not all, jurisdictions.

Sometimes these restructuring techniques or alternative distribution models are nothing more than traditional franchise contracts dressed in non-franchise terms. As indicated in Section I, the names which parties use to describe their relationship do not control the relationship’s legal status. Substance prevails over form.

¹²⁸ See, e.g., La. Rev. Stat. Ann. § 51:445 (2000).

A. Joint Ventures and Corporate Partnering

Companies engaged in distribution programs frequently and mistakenly assume that, by forming a joint venture with an investor, the venture cannot be a franchise. Co-ownership is erroneously regarded as an absolute shield against franchise status. While the assumption is not always wrong, it is always dangerous. As explained in this section, co-ownership is a structuring approach for avoiding the “F” word that may meet with only limited success.

Joint venture describes any association formed to conduct a business enterprise for joint profit.¹²⁹ The essential elements are mutual participation and control to some degree, and a community of interest in the venture’s profits and losses. A joint venture is not a specific type of business entity, and, descriptively, can include both partnerships and corporate entities.¹³⁰

1. *Illustrations in the Franchise Setting*

Joint ventures in the franchise context often come about when a company owning a distribution concept (source partner) solicits investors (investing partners) to form a venture to operate one or more specific locations or businesses. Each venture’s business activities is identified by the source partner’s trademarks and marketing methods, causing all locations and businesses to appear to the public as a cohesive network. The source partner’s contribution to the venture typically is its know-how and trademark license, while the investor’s contribution typically is capital. Commonly, the investor also manages the venture, but not always.

The following chart illustrates the possible joint venture models:

¹²⁹ 46 Am Jur 2d JOINT VENTURES § 1 (2000).

¹³⁰ No specific agreement is required to form a joint venture. Consequently, joint ventures tend to be informal arrangements and treated as partnerships. *Id.* at § 3. Corporate entities entail special formation formalities, but co-venturers may prefer a corporate or LLC model for any number of reasons.

Illustration No.	A	Joint Venture Model: A - Partnership B - Corporate	Source Partner	Investor	Trademark/Fees
	B				
1.	A.	General Partnership	General Partner	General Partner	Source partner assigns all right, title and interest in trademarks to venture
	B.	Corporate	Either majority, minority or 50% owner	Either majority, minority or 50% owner	
2.	A.	General Partnership	General Partner	General Partner	Source partner grants venture a license to use trademarks; venture pays source partner fees for use of marks
	B.	Corporate	50%	50%	
3.	A.	Limited Partnership	General Partner	Limited Partner	Source partner grants venture a license to use trademarks; venture pays source partner fees for use of marks
	B.	Corporate	Majority owner	Minority owner	
4.	A.	Limited Partnership	Limited Partner	General Partner	Source partner grants venture a license to use trademarks; venture pays source partner fees for use of marks
	B.	Corporate	Minority owner	Majority owner	

Illustration 1 is seldom used because it is premised on the source partner transferring its ownership of the intellectual property to the venture. Co-ownership of intellectual property with an unrelated party complicates future expansion and management of the intellectual property portfolio. Consequently, Illustration 1 is an ill-advised business structure.

Illustrations 2, 3 and 4 are each premised on the source partner licensing the intellectual property to the venture. In reality, these illustrations are each two-step transactions: (1) the formation of the venture, and (2) the source partner's grant of a license to the venture permitting the venture to use the source partner's trademarks and know-how subject to controls which the source partner/grantor retains in the license agreement. The second step is no less valid because the source partner owns an interest in the venture. In each of these illustrations, the source

partner wears two hats and plays two independent roles, as (1) co-owner, and (2) intellectual property licensor.

The source partner's control over the venture's activities in Illustrations 2, 3 and 4 is guaranteed by the separate license agreement. The partnership, joint venture, shareholder or comparable type of operating agreement among the venture participants may be an independent source of control, but it need not be. Illustration 4 demonstrates this. There, the source partner is a limited partner or minority owner of the venture. However, as licensor of the intellectual property, the source partner can still dictate limits and obligations for the venture's use of the intellectual property.

Thus, Illustrations 2, 3 and 4 exemplify potential franchise structures because each model is tethered to an independent intellectual property license. Consider the traditional franchise definition: Illustrations 2, 3 and 4 –

First, the *grant of rights* to engage in a business of offering, selling or distributing goods or services exists because of the license which the source partner grants to the venture. The grant is no less valid because the source partner owns an interest in the venture. Nor is it less valid because either the source partner, or the investor, is a limited partner or minority owner, as in Illustrations 3 and 4.

Second, the *marketing plan, community of interest, and control/assistance definitional element* also arises from the license. As explained in subpart III.C.2 below, the distinction between trademark-type licensing controls and controls which satisfy the middle element of the franchise definition, are often imperceptible. When the investor is a limited partner or minority owner (Illustration 3), the source partner's control results from the license as well as from the partnership/shareholder/operating agreement; and

Third, the venture typically pays a *fee* to the source partner for the license. If the relationship is structured with no direct payment for the license, the source partner's share of the venture's profits may constitute an indirect fee satisfying the required fee element of the franchise definition.¹³¹

In Illustration 3, in which the investor is a limited partner or minority owner, formation of the venture may involve the source partner's sale of both a franchise to the venture and a security to the investor. Two different regulatory schemes may be implicated.¹³²

¹³¹ FTC Informal Staff Advisory Opinion No. 98-5 (June 24, 1998), Bus. Franchise Guide (CCH) ¶ 6494 (source partner's receipt of stock and minority ownership interest in joint venture may qualify as a form of payment). But see *In re Matter of Wallach*, 203 NYLJ 3, at 22 (Sup. Ct. NY Co. 1990), Bus. Franchise Guide (CCH) ¶ 9587 (payments to source partner for stock in aircraft brokerage business was not a franchise fee, but a means to establish a shareholder relationship between parties).

¹³² See California Comm'r Op. 73/4F (Feb. 1, 1973), 1973 Cal. Sec. LEXIS 199 (Commissioner of Corporation's advisory opinion finding that limited partnership was not a franchise where general partner (source partner) had the sole right to operate an automotive tune-up business, but might be a security subject to regulation and registration under the California Corporate Securities Law).

These illustrations point out the fallacy of assuming that a joint venture is never a franchise or that co-ownership always shields a source partner from liability as a franchisor.

The joint venture format has other shortcomings. Most significant, participants in joint ventures owe each other fiduciary duties like partners.¹³³ Likewise, majority shareholders owe fiduciary duties to minority shareholders.¹³⁴ Franchisors, on the other hand, have successfully defended arguments that seek to cast the franchise relationship as a fiduciary one.¹³⁵ On this basis alone, the joint venture model, whether structured as a partnership or corporate entity, may not be a desirable alternative for avoiding franchise regulation.

2. *Statutory Treatment of Joint Venture Models*

These illustrations exemplify joint venture models that may qualify as a franchise. As discussed in Section I, status as a franchise is based purely on statute. All relationships that fit the statutory definition are franchises unless they qualify under an express exclusion or exemption.

a. *FTC Rule*

The FTC Rule is the only jurisdiction providing an exclusion for certain joint ventures by expressly excluding general partnerships.¹³⁶ The Rule does not directly address any other corporate models although they have been the subjects of FTC advisory opinions. Pending amendments to the FTC Rule would eliminate the general partnership exclusion.¹³⁷

None of the states with general franchise laws provide a comparable exclusion for general partnerships or for any other type of corporate model involving independent investors.¹³⁸

Only the partnership models in Illustrations 1 and 2 potentially qualify for the FTC Rule's general partnership exclusion since the exclusion is only available when all parties are general partners. The FTC interprets the general partnership exclusion "very narrowly" and

¹³³ 46 Am Jur 2d JOINT VENTURES § 9 (2000).

¹³⁴ 18A Am Jur 2d, CORPORATIONS § 764 (1985).

¹³⁵ *Broussard v. Meineke Discount Muffler Shops, Inc.*, 155 F. 3d 331, 347 (4th Cir. 1998), Bus. Franchise Guide (CCH) ¶ 11,459.

¹³⁶ FTC Rule at § 436.2(a)(4)(i), *supra* note 16. For an excellent discussion of the FTC Rule's general partnership exclusion see Carolyn G. Nussbaum and Leonard D. Vines, Alternative Business Structures For The Franchise System, 23rd Annual Forum, ABA Forum on Franchising (2000), Tab 14.

¹³⁷ FTC NPR *supra* note 18 at 57320-21. The FTC's proposal to eliminate the general partnership exclusion has generated virtually no public comment to date. The FTC claims "the franchise community has become very familiar with the Rule's requirements, including the definition of the term franchise," and its move to eliminate all of the existing FTC Rule exclusions, including the partnership exclusion, does not signal a change in enforcement policy, but is meant to streamline the Rule.

¹³⁸ Georgia and Ohio each exempt general partnerships from state business opportunity laws. But, there is no comparable exemption for partnerships under state general franchise sales or relationship laws.

focuses on substance over form and specifically on issues of “control and unfair advantage.”¹³⁹ The degree of control identifying a true general partnership may not exceed that customarily retained by franchisors over franchisees.

FTC staff advisory opinions indicate that:

The existence of multiple general partnerships, each one similarly structured to own and operate one, or a specific number of, locations using similar operating methods and trademarks, disqualifies the whole scheme for the exclusion.¹⁴⁰

General partnerships, where one partner contributes trademarks and know-how, and other contributes capital, will not qualify for the exclusion. The FTC has said that the potential for deceptive and unfair business practices in these arrangements is no less than in the franchise model.¹⁴¹

Arrangements which shield the franchisor from liability, or allow for an imbalance in the sharing of liabilities to the detriment of the investor partner, will not qualify for the exclusion.¹⁴²

General partners will not be regarded as such when one partner can unilaterally restrict the other partner by imposing, for example, non-competition clauses or territorial limitations, or may terminate or force the transfer of another partner’s partnership interest.¹⁴³

Not only is the FTC Rule exclusion confined to *bona fide* general partnerships, it is available only in non-registration states, limiting the exclusion’s overall utility.

The FTC staff has also said that corporate joint ventures, like that shown in Illustration 4, may be a franchise.¹⁴⁴ A 1998 advisory opinion considered a plan involving a series of corporations, each controlled by a different investor as the majority shareholder with the promoter as the minority shareholder. The promoter licensed each corporation to use its trademarks and business systems. The promoter deferred collecting any fees from the corporation until after the first six months of operations to take advantage of the FTC Rule’s

¹³⁹ FTC Informal Staff Advisory Opinion Nos. 93-4 (March 3, 1993), Bus. Franchise Guide (CCH) ¶ 6447 and 93-3 (March 3, 1993), Bus. Franchise Guide (CCH) ¶ 6448. Issued on the same date, these opinions are the primary authority on the FTC’s view of the general partnership exclusion.

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ FTC Informal Staff Advisory Opinion No. 98-5 (June 24, 1998), Bus. Franchise Guide (CCH) ¶ 6494.

minimum payment exemption.¹⁴⁵ However, the FTC found a franchise fee in the promoter's right to share in the venture's profits as a minority shareholder. Unless the promoter could show, based on industry statistics, the promoter's own financial history, and the experience of other investors, that the parties had no reasonable expectation when they formed the venture of any profits during the first six months, the promoter's minority stake would constitute a franchise fee even if no money was in fact paid during that time. The right to receive prospective, unspecified payments will constitute a required fee when the parties reasonably expect those payments to exceed \$500 during the first six months of operations.

Earlier this year, the FTC issued an advisory opinion squarely addressing the corporate model shown in Illustration 3.¹⁴⁶ A promoter proposed to spin off a chain of restaurants into a series of separate corporations, each of which it would retain control of and sell minority stakes to relatives and friends. The promoter's separate corporation, which owned the trademarks, recipes, trade dress and related intellectual property, would grant each corporation a non-exclusive license.

The promoter assumed that either the sale of franchises to insiders, or the common ownership of the franchisor and franchisee, qualified the arrangement for an exemption, but none existed, the FTC advised.¹⁴⁷ The FTC went even further: *every* investor owning *any* interest in a corporate franchisee had a separate right to receive disclosures regardless of the size of their interest. The franchisor's control of the corporate franchisee did not eliminate the disclosure duty to minority owners.

However, a series of limited liability companies based on the corporate model shown in Illustration 3, in which the promoter kept a majority interest and a strategic partner received a minority share in exchange for sweat equity was not a franchise, according to the FTC, because there was no required fee.¹⁴⁸ The strategic partner's labor contribution did not constitute a *payment*, and even though the strategic partner immediately became liable for the venture's losses, the promoter carefully deferred the obligation to pay losses for six months in order to take advantage of the minimum payment exemption.

b. State Franchise Laws

Even if a relationship qualifies for exclusion from the federal franchise definition as a general partnership, the exclusion offers little help under state franchise laws. As noted, none of the states with general franchise sales or relationship laws recognize the general partnership exclusion.

¹⁴⁵ The minimum payment exemption is discussed in Sections I.C.3.e and III.B, and accompanying notes.

¹⁴⁶ FTC Informal Staff Advisory Opinion 01-02 (May 10, 2001), Bus. Franchise Guide (CCH) ¶ 6510. The opinion assumed that the definitional elements were met and only discussed the ownership issue.

¹⁴⁷ The FTC acknowledged that the ongoing Rule amendment process would add an exemption for franchise sales to corporate insiders. *See* FTC NPR, *supra* note 18 at 57322.

¹⁴⁸ FTC Informal Staff Advisory Opinion 01-1 (March 5, 2001), Bus. Franchise Guide (CCH) ¶ 6509.

There is relatively little authority which has considered whether an arrangement falling within one of the joint venture models is a franchise under state law. For the most part, the little authority that does exist has not hesitated to classify joint venture arrangements as franchises.

In a ruling pre-dating the FTC Rule (and adoption of the general partnership exclusion), California regulators advised that a series of partnerships, each formed to operate one or more restaurants under a common name, were franchises.¹⁴⁹ The majority owners prescribed the operating methods, licensed the trademarks, required the partnerships to enter into separate supply agreements from which they profited, and were paid management fees in addition to their interest in partnership profits.

In another California administrative ruling, a venture operating a chain of clothing stores was found to be a franchise where the stores were identified by one partner's trademarks, who also reserved exclusive merchandising authority and the right to control the venture's executive committee. The allocation of pre-tax profits between the partners satisfied the franchise fee element.¹⁵⁰

However, where partners previously had had an employment relationship and then formed a partnership in which the former employee had sole control over operations, advertising, training, employee supervision and other business policies, and the former employer provided advertising support and general advice regarding site selection and business methods, and shared certain operating expenses, the California regulators found the marketing plan element missing from the arrangement. Therefore, the partnership was not a franchise.¹⁵¹

In *Huedner v. Sales Promotion, Inc.*,¹⁵² a Washington state court found a partnership arrangement providing for the rental of tire customizing machines and permitting use of a dealer authorization logo to be a franchise under the Washington statute.

While various joint venture arrangements may be implemented to achieve financial or other goals, avoidance of the franchise laws, at the federal or state level is not easily accomplished.

B. Avoiding the “Franchise Fee”

As businesses structure licensing or distribution arrangements to achieve business goals, these structures may employ one or more techniques to avoid the franchise label. As discussed in Section I.C.2.b. above,¹⁵³ the marketing plan element is easily satisfied. Also, the trademark

¹⁴⁹ California Comm'r Op. 79/2F (Feb. 26, 1979), 1979 Cal. Sec. LEXIS 21.

¹⁵⁰ California Comm'r Op. 4736F (Nov. 14, 1983), 1983 Cal. Sec. LEXIS 2. Although the opinion does not clearly say that the arrangement was specifically formed as a partnership, it refers to the participants as partners.

¹⁵¹ California Comm'r Op. 4743F (Nov. 25, 1983), 1983 Cal. Sec. LEXIS 1.

¹⁵² 38 Wn. App. 66, 684 Pac. 2d 752, (Wash. Ct. App. 1984), Bus. Franchise Guide (CCH) ¶ 8215, cert. denied 474 U.S. 818 (1985).

¹⁵³ See discussion at Section I.C.2.b. of the text and accompanying notes.

element, for one, is exceedingly difficult to avoid in any jurisdiction since, as noted,¹⁵⁴ the test in most jurisdictions is *substantial association*, not actual use, a standard which has been expansively interpreted. The avoidance techniques often focus on the franchise fee element.

1. *Bona Fide Wholesale Price*

For commercial arrangements involving the sale of products from the grantor to the distributor or franchisee, the *bona fide* wholesale price exception is a sound structural alternative to avoid the franchise fee element in all but a handful of jurisdictions.¹⁵⁵ All of these jurisdictions exclude from their definition of a franchise fee payments which do not exceed the *bona fide* wholesale price of goods, *i.e.*, inventory purchased for resale.¹⁵⁶ Consequently, when the distributor's only payment to the supply source is for the *bona fide* wholesale price of goods, the distribution arrangement is not a franchise because the fee element is missing. In most jurisdictions, to qualify for the *bona fide* wholesale price exemption, the products purchased must be inventory products for resale. Supplies and equipment, marketing material, or other items will not qualify. Therefore, bundling the sale of inventory, along with equipment, supplies and/or services, will surely doom any attempt to avoid the franchise fee definition.

Several jurisdictions include "services" in the definition of *bona fide* wholesale price transactions.¹⁵⁷ Other jurisdictions recognizing the *bona fide* wholesale price exception expressly confine the exception to the sale of goods. Nevertheless, an argument can be made that the rationale¹⁵⁸ underlying the *bona fide* wholesale price exception justifies extending the exception to wholesale purchases of services. As discussed in Section IV below, certain commercial distribution arrangements may involve the sale of services to dealers at wholesale, who resell the services to retail customers. Practitioners should consider this yet untested expansion of the *bona fide* wholesale price exception as a franchise fee avoidance technique.

Although little guidance exists on what exactly qualifies as a *bona fide* wholesale price, it is generally understood to mean a price that is greater than the supply source's cost to manufacture the goods, but less than a retail price.¹⁵⁹ There is no reason a supply source cannot

¹⁵⁴ See discussion at Section I.C.2.a of the text and accompanying notes.

¹⁵⁵ Arkansas, Connecticut, Missouri, New Jersey, Wisconsin, Puerto Rico and Virgin Islands each have relationship laws that define a franchise without reference to payment of a required fee.

¹⁵⁶ The rationale underlying the *bona fide* wholesale price exception to the franchise fee definition is that, as long as the distributor is not forced to buy excessive quantities of inventory, it can resell the goods and recoup its investment and, thus, does not need the protection of franchise laws. An open and public market must exist for the goods, and only payments for goods, *i.e.*, inventory, qualify for the exception. See Section I.C.2.c and accompanying notes. A franchise fee will be found to the extent the distributor must buy excessive quantities. See *Watkins & Pet Supplies v. Iams Co.*, *supra* note 85 at 890. Purchase quotas could cross the line into excessive, and therefore, an unreasonable quantity of products, if many distributors are unable to sell the inventory purchased from the grantor/manufacture.

¹⁵⁷ See, *e.g.*, Hawaii, Business Registration Regulations, Title 16, Chp. 37, Section 16-37-1; and Maryland, Code of Maryland Regulations, Section 02.02.08.03.C.

¹⁵⁸ See note 156 *supra*.

¹⁵⁹ *Sports Racing Servs.*, *supra* note 85 (acknowledging that selling goods at prices higher than the seller's cost still qualifies as a *bona fide* wholesale price). But consider a recent not-for-publication California appellate court (*footnote continued on next page*)

charge different *bona fide* wholesale prices based on valid cost differentials, such as differences in order sizes (volume discounts), shipping costs, and regional variances in manufacturing costs.¹⁶⁰ The burden of proving *bona fide* wholesale price remains with the supply source, no different than the burden of proving the application of any other statutory exclusion or exemption.

2. *Minimum Payments*

Another avoidance mechanism involves limiting the total fee that a franchisee or dealer is required to pay. As discussed above in Section I.C.2.b., the franchise fee under the FTC Rule can be avoided if payments to the franchisor within the first six months of operation do not exceed \$500. Many of the state franchise investment laws do not have a comparable \$500 threshold, or do not have a time period in which the dollar threshold is measured. Therefore, this exclusion is not available in some of the most populated states in the country, and is of limited utility for a nationwide franchise or distribution arrangement.

Besides the few jurisdictions which define a franchise without the fee element,¹⁶¹ three other potential traps exist that can foil a supply source's design to avoid franchise regulations based on minimum or no fees.

First, there are overlooked, innocuous fees, the kind that may be tacked on innocently enough during the course of a franchise distributorship relationship, but which, at some point, exceed a statutory dollar threshold and, then, instantly convert an unregulated relationship into a franchise. This is exemplified by *To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift America, Inc.*,¹⁶² a case which arose after Mitsubishi terminated To-Am's distributorship on short notice, without cause. To-Am argued that its distributorship was a franchise and sued Mitsubishi for wrongful termination without good cause in violation of Illinois' franchise law. The case centered on whether To-Am had paid Mitsubishi a franchise fee.

There was no dispute that To-Am's payments for Mitsubishi tractors satisfied the *bona fide* wholesale price exception, but To-Am maintained that a franchise fee existed in its mandatory purchases of Mitsubishi sales and service manuals. While small and incremental, To-Am's payments for manuals eventually exceeded Illinois' \$500 threshold. Thus, while the parties' relationship was not a franchise at the outset, it was one by the time Mitsubishi ended To-Am's distributorship.¹⁶³ The court awarded To-Am \$1.5 million for the wrongful termination

(footnote continued from previous page)

decision, which held that Amoco's "established distributor book price" minus a standard discount could have exceeded a *bona fide* wholesale price. *US Mac Corp. v. Amoco Oil Co.*, Bus. Franchise Guide (CCH) ¶ 11,963 (Cal. Ct. App. 2000) (unpublished).

¹⁶⁰ These kinds of cost differentials are comparable to those recognized by the Robinson-Patman Act.

¹⁶¹ See discussion at note 155 *supra*.

¹⁶² 152 F. 3d 658 (7th Cir. 1998), Bus. Franchise Guide (CCH) ¶ 11,456.

¹⁶³ The District Court noted that both parties assumed and that the \$500 threshold could be met by incremental payments accumulating to more than \$500 over time, and questioned whether such a position can be reconciled with the statute. *To-Am Equipment Co. Mitsubishi Caterpillar Forklift of America*, 953 F. Supp 987,993 (N.D. (footnote continued on next page)

without good cause, rebuking Mitsubishi for believing that contract labels could save a relationship from regulation:

“Legal terms often have specialized meanings that can surprise even a sophisticated party...[Mitsubishi] “like many manufacturers ... simply did not appreciate how vigorously Illinois protects ‘franchisees’.”¹⁶⁴

For the same reason, automobile and truck dealerships may be accidental franchises waiting to be noticed. When the FTC Rule was promulgated, automobile and truck manufacturers lined up for exemptions from the FTC on the basis that the only money which their dealers paid them was the *bona fide* wholesale price for the vehicles.¹⁶⁵ However, over time and with inevitable management changes, the reasons for not charging dealers for the various support services being extended may have been forgotten or ignored. At least some manufacturers today reportedly impose small miscellaneous fees, often for marketing and advertising support or sales aids. While these charges may be fair in light of the assistance being provided, they are potential franchise fees nonetheless.

Second, there are fees which, while denominated optional, are nevertheless being paid by the majority of system members. While franchise fees are confined to payments *required* as a condition to obtaining distribution rights, a nominally optional payment will be classified as a required one if the payment is *practically necessary* for the successful operation of a business.¹⁶⁶ When a majority of system members choose to make the same ostensibly voluntary payment, their independent decisions resonate that the payment may benefit the bottom line and, therefore, is necessary, practically speaking. A franchisor, without intending to collect a franchise fee, may be deemed to have done so by virtue of the system-wide response to an optional charge.

(footnote continued from previous page)

Ill. 1997). Because Mitsubishi never challenged the “accumulation” theory, the judge did not, and could, rule on the viability of this position. *Id.* While the Court of Appeals noted that the statute expressly permits installment payments, indefinite in amount, to be considered a franchise fee, the Court recognized that a question of fact could exist as to whether incremental payments would reach the \$500 threshold to fall within the scope of the statute.

¹⁶⁴ *Id.* at 659, 666.

¹⁶⁵ *See, e.g.*, FTC Informal Staff Advisory Opinions issued to Chrysler Corp., General Motors, American Motors, Ford, Volkswagen, among others, issued in August, 1979, two months before the FTC Rule took effect, appearing at Bus. Franchise Guide (CCH) ¶¶ 6384-6387. *See also* petition of Daewoo Motor America, Inc. for an exemption from the FTC Rule dated Sept. 6, 2000, Bus. Franchise Guide (CCH) ¶ 11,946. Daewoo requested an exemption on the basis that its dealers are sophisticated business persons with experience in the industry, the process of purchasing a dealership ordinarily takes several months, ensuring adequate time for prospective dealers to investigate all relevant information, and it would be counterproductive for Daewoo to resist supplying information to prospects since it would hurt Daewoo’s ability to sell new dealerships. At the time this paper was submitted for publication, no official action had been taken even though the public comment period ended in November, 2000.

The FTC Rule currently contains no industry-specific exclusions or exemptions from the franchise definition. The FTC’s proposed Rule amendments would add an exemption for petroleum marketers and resellers, among others. FTC NPR, *supra* note 18 at 57320.

¹⁶⁶ Release 3-F, *supra* note 18 at 7823; Interpretive Guides, *supra* note 31, at Bus. Franchise Guide (CCH) ¶ 6207.

Lastly, there are potential hidden, or indirect, fees. While the outcomes vary, plaintiffs persist in advancing creative arguments that particular payments are indirect franchise fees.¹⁶⁷

3. Commission-Based Relationships

A commission-based relationship, in which the putative franchisee does not make any payments to the putative franchisor or principal, or to its affiliates, can avoid the franchise fee element. To avail itself of this agency/commission exclusion, a business needs to structure its distribution arrangement so that payments from customers, or the ultimate end-users, are made to, or directed to, the grantor or principal. The principal would pay the agent or distributor a commission, as compensation for the agent's effort in selling or promoting the product. The FTC, in its Interpretive Guides, has expressly stated that an "agency relationships in which the independent agents, compensated by commission, sell goods or services (*e.g.*, insurance salespersons) are excluded [from the coverage of the FTC Rule], since there is no "required payment."¹⁶⁸

While the state laws do not have explicit agency/commission exemptions, judicial opinions appear to provide some guidance, and some comfort, to business entities that attempt to structure their distribution arrangements in this manner.¹⁶⁹

The utility of an agency/commission structure will be lost if the principal charges or requires the payment of any other fees in connection with the business.¹⁷⁰ Further, an argument may be made that a commission may be viewed as a hidden franchise fee, if the principal or franchisor retains a larger percentage of the revenue stream than might otherwise be payable to the dealer/franchisee. For example, a hidden franchise fee could be detected if the principal has established different commission structures for different types of independent agents, distributors, and employees who may perform similar services in different locales; a commission rate that varies with the services provided by the franchisor; or a commission structure that is lower than the industry standard for such services.

As discussed above at Section II.B, an agency/commission relationship may be subject to state sale representative laws.¹⁷¹

¹⁶⁷ For an example of a plaintiff's inventive argument on the franchise fee issue, see *SPX v. Shop Equipment Specialists, Inc.*, 2001 U.S. Dist. LEXIS 4602 (E.D. Mich. 2001) (rejecting as "utterly frivolous" defendant's argument that a commission in a proposed agreement which defendant never signed and never paid constituted a franchise fee).

¹⁶⁸ Interpretive Guides, § I.A.1.c. *supra* note 31, at Bus. Franchise Guide (CCH) ¶ 6207.

¹⁶⁹ *Account Serv. Corp. v. DAKCS Software Serv. Inc.*, 567 N.E.2d 381 (Ill. App. Ct. 1990). See also discussion of insurance agents at Section IV.C below.

¹⁷⁰ Other fees could include payments for rent, advertising assistance, equipment, supplies, training, security deposits, escrow deposits, bookkeeping charges, promotional literature, or other matters. FTC Statement of Basis and Purpose, *supra* note 8, at 59,703-06.

¹⁷¹ This structure will not avoid the franchise definition in the five states (Arkansas, Connecticut, Missouri, New Jersey and Wisconsin), and Puerto Rico that have franchise relationship laws that do not include a minimum franchise fee as a required definitional element.

C. Exemptions and Exclusions

If avoiding the franchise label cannot be achieved by eliminating a definitional element, a company may achieve the same result, or at least reduce the regulatory burdens, if it can qualify for a statutory or regulatory exemption or exclusion. The following sections discuss the most popular exemptions and exclusions.

1. Fractional Franchise

The “fractional franchise” exemption is an often-considered exemption from the franchise laws – available under the FTC Rule¹⁷² and several states (California, Illinois, Indiana, Michigan, Minnesota, Virginia, and Wisconsin).¹⁷³ Under the FTC Rule, a fractional franchise exists when an established distributor adds a franchised product or service line to its existing line of goods or services. Two conditions must be met to satisfy this exemption. First, the franchisee or any of its current directors or officers must have more than two years of prior management experience in the business represented by the franchise. Second, the parties must have, or should have, anticipated, in good faith, at the time of entering into the franchise arrangement, that the sales arising from their proposed relationship would be no more than 20% of the dollar volume of the franchisee’s projected gross sales within at least the first year after the franchisee begins selling the goods or services offered by the franchised business.¹⁷⁴ While the FTC exemption requires that the snapshot of the multi-line distributor’s future performance be taken only once, at the start of the relationship, several states, including California, require that the 20% threshold be re-evaluated annually.

The FTC has, in its interpretive opinions, limited the application of the fractional franchise to situations in which the franchisee clearly has the experience in the business of the franchised product, but the ultimate analysis is very fact-specific. The FTC staff noted that the fractional franchise exemption is not equivalent to a “sophisticated investor” exemption.¹⁷⁵

The benefits of the fractional franchise exemption are limited. The exemption is available only under the FTC Rule and a handful of state registration/disclosure laws.¹⁷⁶ In addition, it does not exempt a franchisor from the state franchise relationship (termination, nonrenewal) laws, or from the anti-fraud provisions of the state franchise laws.¹⁷⁷ Also, not all

¹⁷² 16 C.F.R. §436.1-3.

¹⁷³ See Appendix A.

¹⁷⁴ The purpose underlying this exemption for fractional franchise relationships is that franchisees with a particular level of experience who are undertaking a limited investment do not require, or will not benefit from, the disclosures required by the FTC Rule. The FTC has assumed that these franchisees have sufficient familiarity with the cost, profits, and business obstacles of distributing similar goods and services. Furthermore, the franchisee’s experience should reduce his or her dependence on the expertise of the franchisor. Finally, the franchisee will not be substantially dependent on the sales of the franchised product for his or her own success.

¹⁷⁵ FTC Informal Staff Advisory Opinion 97-1, *supra* note 59; see also discussion at Section IV.A.2, below.

¹⁷⁶ The requirements under laws vary slightly from state to state.

¹⁷⁷ See, e.g., Minnesota Franchise Law, Section 80C.13.

of the state business opportunity laws contain exemptions similar to the fractional franchise exemption.¹⁷⁸

The fractional franchise exemption is most likely to be of value to business relationships in which the grantor or licensor has developed a new product, technique, process, or method of doing business, which is offered to an existing business to augment its revenue. While we have seen it applied in the healthcare field,¹⁷⁹ businesses that develop and distribute new technologies will most likely offer these new technologies, products, and services to businesses or distribution networks that have some familiarity with the technology.

2. *Single License*

While the FTC Rule excludes single trademark licenses, referred to by the Rule as *unique licenses*, none of the regulating states recognize a comparable exclusion or exemption.¹⁸⁰ Therefore, the utility of the single trademark license is highly limited.¹⁸¹

Even at the federal level, the distinction between a single trademark license, on the one hand, and a business format franchise, on the other, is not easily drawn. The FTC's Final Guides and Statement of Basis and Purpose, written when the Rule was first released in 1979, imply that a licensor may rely on the single license exclusion in connection with several single licensing arrangements. However, a recent FTC interpretive opinion casts doubts on that interpretation by stating that the exclusion is available only when a licensor grants a single, solitary license and no possibility exists for the licensor to grant a second license to anyone else.¹⁸²

¹⁷⁸ See, for example, under California Seller Assisted Marketing Plan Law, the law does not apply to the sale of a business opportunity to an enterprise which also sells or leases equipment, products, or supplies which are not supplied by the business opportunity seller, and the purchaser does not utilize the equipment, products, supplies, or services of the seller if the equipment, products, supplies, or services not supplied by the seller account for more than 25% of the purchaser's gross sales, Sec. 1812.201(b)(6).

¹⁷⁹ See discussion at Section IV.A, below.

¹⁸⁰ FTC Rule 16 C.F.R. §436.2(a)(4)(iv). The types of trademark licenses that are exempt for the Rule's coverage include (a) licensing arrangements in which a single licensee is granted the right to use the trademark; (b) licensing of a trademark to a single licensee who manufactures the trademarked goods according to the licensor's specifications ("one-on-one" licensing); (c) licensing of a trademark that is well known in one context (e.g. designer clothing) for use in another context (e.g., linens or luggage ("collateral product") licensing); and (d) licenses entered into in the course of settlement negotiations in a trademark infringement action, where the licensor grants the allegedly infringing party a license to use the trademark for a specified period of time. Interpretive Guides, *supra* note 31, at § I.A.3.h (Bus. Franchise Guide (CCH) ¶ 6217).

¹⁸¹ Several states franchise investment laws (Illinois, Indiana, Minnesota, New York, Washington) have exemptions from the registration requirements for isolated or a limited number of franchise sales in the states. See Appendix A. These exemptions generally do not exempt a franchisor from disclosure, and do not relieve a franchisor of compliance with the anti-fraud provisions of the state laws.

¹⁸² The Statement of Basis and Purpose, § V.A.2.e.(4) (at Bus. Franchise Guide (CCH) ¶ 6350) notes that the exclusion for single trademark licenses "involves very limited numbers of licensees" (but the FTC, in a footnote (fn 108), states that the exclusion is not available for more than one license). A March 2000 FTC interpretive opinion, FTC Informal Staff Advisory Opinion 00-3, March 20, 2000, Bus. Franchise Guide (CCH) ¶ 6507, stated that unless the license for which the licensor sought a safe harbor under the single license exclusion covers the entire U.S., and precludes other licenses, the exemption is not available, even if licensor has no intent to, and in fact does not, grant other licenses.

3. “Large/Experienced” Franchisor or “Blue Chip” Exemption

As noted above, several state statutes and/or regulations provide exemptions for the offer and sale of franchises made by franchisors who have a substantial net worth and/or have significant franchise or operating experience.¹⁸³ The large/experienced, or blue chip, franchisor exemption, in most cases, exempts a franchisor only from state registration requirements, not from disclosure obligations or the state statute’s anti-fraud provisions. Moreover, there is no federal counterpart, so even the blue chip franchisor remains subject to the FTC Rule’s disclosure obligations. Notwithstanding that the exemption offers blue chip companies relief from certain regulatory burdens, it does not provide blue chip companies with an escape from the “franchise” definition altogether.¹⁸⁴

4. *Sophisticated or Experienced Franchisees*

Although purporting to pattern themselves after federal securities laws, few state franchise investment laws recognize an exemption for sophisticated investors of the kind embraced by the federal securities laws. Sophistication in the federal securities law context is based on a combination of income, net worth and experience at a level indicative of an ability to assess risk and possibly absorb losses.

Six franchise regulatory states -- California, Illinois, Maryland, Rhode Island, Washington, and Wisconsin¹⁸⁵ -- exempt sales to sophisticated *or* experienced franchisees, varying significantly in their approach. The California exemption, for example, is strictly based on the franchisee’s experience in the same type of business. The other states use different combinations and thresholds of net worth, investment size, and experience. Because of the limited availability of the exemption and the wide variations in definitional approach, this structuring device offers limited value except in select situations.

As noted in Part IV below, and as a cursory review of the franchise, hotel, and restaurant trade press will indicate, franchise ownership is not the lone province of mom and pop investors. Public companies, some with multi-national and multi-brand operations, and some with net worth levels that exceed some of their licensors, can be counted in the ranks of franchisees. Given the mega-size of some accidental franchisees (as well as traditional franchisees), it is difficult to make a case that they, as a class, warrant regulatory protections. As noted,¹⁸⁶ the

¹⁸³ Often, the net worth requirement can be met, in part, by a parent that owns at least 80% of the franchisor with sufficient net worth, if that parent is willing to issue a guarantee of the franchisor’s obligations to its franchisees. The criteria and procedures for qualifying for this large/experienced or “blue chip” exemption differ from state to state. The net worth threshold ranges from \$1 million (in New York under one form of exemption, with a parent guarantor) to \$15 million (also in New York). In addition, in most states (other than New York), the statutes require that the franchisor have at least 25 franchisees conducting business during the five-year period immediately preceding the offer or sale of an exempt franchise, or have at least 25 outlets that have been operating for the five-year period. *See* Appendix A.

¹⁸⁴ Several business opportunity laws also have exemptions for sellers with a high net worth. *See* Appendix C.

¹⁸⁵ *See* Appendix A.

¹⁸⁶ *Supra* note 18.

FTC's NPR proposes to add a sophisticated franchisee exemption to the FTC Rule, something which every state jurisdiction should consider as well.

D. Product Distributorships – An Example

Product distribution systems -- where manufacturers enlist independent contractors to offer, sell or distribute the manufacturer's products -- are an example of a commercial arrangement that can often successfully be structured using several of the above-described approaches to avoid the reach of franchise laws.

In the typical product distributorship, the three definitional elements potentially co-exist: (1) a manufacturer or supplier (supply source) grants an independent operator (distributor) the right to distribute and sell the supply source's products and thereby identify with the supply source's trademarks, if not pursuant to an express license then by an implied one through the right to sell logo products; (2) the distribution rights are often coupled with the supply source's marketing-type controls or assistance; and (3) the distributor makes payments to the supply source. Despite the appearance of all three definitional elements, manufacturers have a number of structuring options.

As discussed above, the FTC Rule and a handful of states exempt *fractional franchises* not from the definition of a franchise, but from compliance obligations.¹⁸⁷ Generally, these exemptions are available to multi-line distributors when the parties in good faith anticipate that the distributor's sales from any one source will not exceed 20% of the distributor's total projected future sales. In some states, the uncertainty of a distributor's future performance from one year to the next makes reliance on the exemption somewhat precarious.

When the fractional franchise exemption is not available or a distributor's dependence on a supply source exceeds the 20% threshold, the avoidance approach that supply sources commonly turn to, and certainly the most objectively dependable avoidance technique, is for the supply source to (i) limit payments from distributors to the *bona fide* wholesale price of inventory, and (ii) avoid imposing excessive purchasing obligations on distributors that can reasonably be expected to result in over-stock conditions.

Of course, limiting a distributor's payments to reasonable quantities of inventory at *bona fide* wholesale prices may not satisfy a supply source's economic objectives. Thus, the supply source may focus on eliminating a different definitional element. Most likely, the supply source's strategy will target getting rid of the marketing plan/community of interest element since every distributorship, by nature, involves a grant of rights to distribute another's goods.

*Hartford Electric Supply Co. v. Allen-Bradley Co.*¹⁸⁸ points out the difficulty of structuring a product distributorship without the marketing plan or trademark element. The

¹⁸⁷ 16 C.F.R. § 436.2(a)(3)(i) and § 436.2(h) (FTC Rule fractional franchise exemption). California, Illinois, Indiana, Michigan, Minnesota, Oregon, Virginia and Wisconsin also provide comparable fractional franchise exemptions.

¹⁸⁸ *Supra* note 26.

Connecticut Supreme Court advanced a sweeping interpretation of Connecticut's two-prong franchise definition (marketing plan *plus* substantial association with the grantor's mark), with language that captures virtually every Connecticut distribution agreement. The court held that: (1) even though the distribution contract denied the manufacturer control over the distributor's pricing, the manufacturer's influence over pricing, demonstrated by plain-vanilla conduct like printing product catalogues with suggested prices, controlling national account transactions, and criticizing cost-cutting distributors, was enough to evidence a marketing plan, and (2) the distributor's use of product catalogues and promotional materials bearing the manufacturer's logo satisfied the substantial association requirement even when the distributor represented multiple lines and was not dependent on any one brand.

For this reason, there are limited avoidance alternatives available to product distributorships beyond *bona fide* wholesale pricing (which, itself, is not universally available). For a general discussion of franchise avoidance techniques for product manufacturers, see *When Does A Product Distribution System Become a Franchise or Business Opportunity*, delivered at the 1991 ABA Annual Forum by Kennedy A. Brooks, Clay A. Halvorsen and Rochelle B. Spandorf.

E. Traps of Other Laws

While structuring to avoid a definitional element may save a relationship from being regulated as a franchise, it may not save the relationship from being regulated under related regulatory schemes.

1. Business Opportunity Laws

Avoidance of the franchise laws may subject the revised structure to the business opportunity laws. For example, eliminating the franchise fee, by charging no fees, and selling only products to the purchaser at *bona fide* wholesale prices, does not escape the payment element of the business opportunity laws.¹⁸⁹ Also, reducing payments below the FTC Rule's \$500 minimum payment may only avoid the business opportunity laws in about one-half of the states.¹⁹⁰

Avoiding the franchise label by eliminating the license to use the trademark will not exclude the relationship from the business opportunity laws, because there are many other representations that can be made by the seller that will bring the arrangement under the law.

¹⁸⁹ Most business opportunity laws include in their definition a seller who furnishes goods (or services) for a payment of \$500 or more, and do not contain a *bona fide* wholesale price exception.

¹⁹⁰ To successfully avoid all of the business opportunity laws, the fees must be less than \$400 in some states, and as little as \$200 (in North Carolina). Moreover, to avoid these laws – many of which were designed to regulate business ventures with a relatively low investment or start-up costs – the franchisor must also avoid charging fees for other products and services, such as not-for-profit or sales demonstration equipment, materials, or samples, in excess of \$500. See Appendix B.

Even if a business can successfully minimize its control, assistance or marketing plan to avoid being a franchise, it may not be able to avoid the business opportunity law trap. Almost two-thirds of the business opportunity laws can be triggered by a representation that the seller will provide a sales or marketing program to enable the buyer to derive business income that exceeds the price paid for the business. A marketing plan under these laws can be quite minimal, such as providing buyers with promotional literature, brochures, or advertising materials.¹⁹¹ Additionally, as noted, these laws can be triggered by implied representations arising from the seller's conduct as well as from the seller's express statements.

2. Trademark Laws (Lanham Act)

The heart, or core element, of a franchise relationship is the license to use a trademark or service mark.¹⁹² In essence, a trademark serves several purposes. First, it is an identification of the seller's goods and services. Second, it signifies that all of the goods and services identified by that mark come from, or are controlled by, a single, albeit sometimes in an anonymous, source.¹⁹³ Third, a trademark denotes that all products and services offered under that mark are of an equal level of quality – it need not be high quality, low quality or otherwise, but all products are of the same general quality. Fourth, trademarks are prime instruments in advertising and marketing products for sale.

Under common law and the Lanham Act,¹⁹⁴ the owner of a mark is permitted to grant licenses to third parties to use the mark.¹⁹⁵ When the license is granted, the trademark owner not only has a right to control the quality of the goods and services offered under its mark, but has a duty to control the quality.¹⁹⁶ A licensor must impose certain quality controls on the licensee or franchisee to ensure that the goods and services offered under the licensor's mark are consistent from one outlet to another, and conform to the licensor's standards.

¹⁹¹ See, e.g., Md. Business Opportunity Sales Act, §14-101(c).

¹⁹² One state franchise law, however, the New York franchise sales law, NYGBL, Art. 33, § 680-695, contains alternative definitions of franchise (§ 681.3), and one definition includes the marketing plan element and the fee element, but does not require that the business, or the goods or services offered from the business, be substantially associated with the franchisor/grantor's mark.

¹⁹³ Products that are identified by marks such as GM, FORD, GE, clearly indicate the source origin of the product. (e.g., General Motors Corp. Ford Motor Company, or General Electric Co.) Other marks such as IVORY, TIDE, JOY, and CHARMIN, do not indicate the source of the product but may indicate that they come from a common source, in this case Proctor & Gamble.

¹⁹⁴ Trademark Act of 1946 (Lanham Trade-Mark Act), 15 U.S.C.A. §§ 1051 to 1127.

¹⁹⁵ Although the Lanham Act does not specifically permit trademark licensing, several provisions clearly contemplate licensing. Lanham Act § 5, 15 U.S.C.A. § 1055, and § 45, 15 U.S.C.A. § 1127. Cases interpreting the Lanham Act have acknowledged the right of a trademark owner to grant licenses that impose quality controls. See *Kmart Corp. v. Cartier, Inc.*, 486 U.S. 281 (1988); *Denison Mattress Factory v. Spring-Air Co.*, 308 F.2d 403 (5th Cir. 1962). For a complete discussion of trademarks, see J. Thomas McCarthy, *McCarthy on Trademarks and Unfair Competition*, 4thed., copyright 2001.

¹⁹⁶ *Dawn Doughnut Co. v. Heart's Food Stores, Inc.*, 267 F.2d 358 (2d Cir. 1959); *Gorenstein Enterprises, Inc. v. Quality Care-USA, Inc.*, 874 F.2d 431 (7th Cir. 1989).

If a licensor does not enforce reasonable, albeit sometimes minimal, quality controls, the license may be viewed as an uncontrolled license of the trademark. If the licensee has unfettered discretion to place marks on any product, or to use the marks on products or services that are of varying levels of quality, the trademark may lose its significance and distinctiveness in the market place. Uncontrolled licensing, also known as a “naked” license, can lead to the abandonment of a trademark.¹⁹⁷

In analyzing whether a relationship is a franchise, the controls that the licensor or franchisor places on the licensee or franchisee often satisfy the marketing plan element of a franchise definition. These controls often relate to the goods and services sold, but in many instances, the controls pertain to the operation of the licensee’s business, and the overall experience that a customer receives when visiting a licensed outlet or when purchasing a licensed product.¹⁹⁸

The dilemma for manufacturers or licensors who may be on the cusp of entering into a franchise relationship is determining the appropriate level or degree of quality control. The licensor must set standards of quality and undertake inspections to ensure that the goods and services are offered in a manner consistent with the licensor’s standards, and consistent with the obligation under the trademark law to impose and enforce standards. On the other hand, the level of quality control should not be so high that the trademark license will be viewed as a franchise (assuming the other requisite definitions of the franchise are present). It is virtually impossible to answer, in the abstract, how much quality control is enough, and how much is too much.

It is possible (but not that probable) to structure an arrangement that reduces the elements of a marketing plan to the bare essentials of trademark quality controls. To accomplish this, the agreement (written or oral) should not promise any “assistance” and there should be no marketing plan. The only “controls” should be those related to ensuring that the products or services offered under the trademark meet with the quality assurance standards of the licensor. This may be easier to discern with respect to the licensing of a particular product or service, such as a diagnostic or testing service. It is more difficult when the license pertains to a broader enterprise, such as a retail store.

¹⁹⁷ *Heaton Enterprises of Nevada, Inc. v. Lang*, 7 U.S.P.Q.2d 1842 (TTAB 1988) While complete abandonment and the loss of rights in and to a mark is a potential result from a naked license, some courts have found that an uncontrolled license will cause an abandonment of the mark only in conjunction with the geographic or product markets where the mark has been used and not controlled. *E.F. Prichard Co. v. Consumers Brewing Co.*, 136 F.2d 523 (6th Cir. 1943).

¹⁹⁸ The marketing plan element also may be satisfied due to restrictions somewhat unrelated to quality control and trademark licensing, such as specific types of assistance provided to the franchisee, territorial or customer restrictions, or controls over business operations such as accounting or insurance, which have little or no impact or relation to the goods and services offered under the marks. *But see*, for example, *Horner v. Tilton*, 650 N.E. 2d 759 (Ind. Ct. App. 1995), *Bus. Franchise Guide* (CCH) ¶ 10,698, a case in which the court found that there was no marketing plan and therefore no franchise under Indiana law. The control and oversight exercised by the licensor over the operation of a mail service business was limited to the use and protection of the licensor’s trademark, and did not contain other indicia of a marketing plan.

IV. UNSUSPECTING FRANCHISES IN TODAY'S ECONOMY: THE CASE OF THE ACCIDENTAL FRANCHISE

A. Healthcare Services

Healthcare services and franchising may not appear to have much in common. Franchising is generally viewed as businesses that provide uniform products or services, offered at or from chain or uniform outlets, according to a prescribed method or plan. Healthcare services generally involve the provisions of services, specialized or customized for each patient, being provided by diverse, disparate and independent providers.

The traditional image of healthcare – licensed professionals, providing carefully considered and thorough advice and care on an individualized basis – is evolving, with new and innovative healthcare organizations and delivery systems. Managed care has spawned a variety of new healthcare entities and delivery systems, such as health maintenance organizations, preferred provider organizations, independent practice associations, management service organizations and physician practice management companies. In addition, technology and innovation have led to new techniques, programs, therapies, and treatments that can be offered to patients as part of an individual physician's practice or the services of a managed care organization. As healthcare service organizations seek efficiencies in providing services, and find the need to “compete” for patients and revenue, certain healthcare delivery models may exhibit traits of franchising.¹⁹⁹

To highlight the potential applicability of franchise laws to healthcare providers, one should consider two examples of healthcare organizations or healthcare services: physician practice management companies or PPMCs, and a licensed medical diagnostic technique. A PPMC provides various administrative and marketing services to the physicians in exchange for a management fee. PPMCs may be established as a means by which physicians or groups of physicians operate under a similar name, trademark or service mark, and derive the benefits of increased name, or “brand,” recognition. A second example, for illustrative purposes, is a new medical treatment that involves an optical diagnostic technique and a related therapy. The tests and treatment are marketed under a particular trade name or mark, and are sold or licensed to physicians or practice groups who offer the testing and therapy to their patients. As discussed

¹⁹⁹ This section of the text addresses the delivery of healthcare services, by licensed professionals, in an alliance, or setting, which may otherwise be considered antithetical to traditional franchising, and therefore, may be susceptible to being an *accidental* franchise. In addition, while not the focus of this section, or this article in general, there are businesses that serve or support the healthcare industry (*e.g.*, home healthcare agencies, optical stores, home infusion therapy businesses), supply healthcare related products (*e.g.*, medical devices; vitamins), and operate healthcare related retail operations (*e.g.*, pharmacies and drug stores, weight loss programs, vitamin and nutrition stores) and may distribute their products or services through traditional distribution or licensing methods. Also, in these businesses, the nature of the product or service offered, the person or entity providing the product or service, and/or the control (if any) exercised by a licensor, manufacturer, or grantor, is often more akin to traditional business format or product distribution franchises, than to the healthcare services discussed in this section. For businesses such as these, the franchise model may not be “accidental,” but may be actively embraced by these systems.

below, these two models may bear traits typically associated with franchising, and may be subject to the franchise laws.

1. Application of the “Franchise” Definition

By reviewing the healthcare providers discussed above in the light of the franchise laws (and other business regulatory structures), it is possible to see how certain healthcare organizations service providers, or arrangements for the provision and/or distribution of healthcare services, could fall within the definition of a franchise.

a. Trademark

In many cases, a determination of whether the trademark element is satisfied is quite simple. In the PPMC and licensed technology models discussed above, the trademark element is arguably satisfied by the use of the mark in the name of the business, or in connection with promoting the licensed diagnostic and therapy services. For the trademark element to be satisfied under most state franchise laws, the franchisee’s business must be “substantially associated” with the franchisor’s trademark.²⁰⁰ To determine whether a franchisee, licensee or dealer has been given the right to distribute goods or services which are “substantially associated” with a licensor or manufacturer, it is necessary to consider whether the commercial symbol is brought to the attention of the licensee’s customers to such an extent that they would regard the licensee’s business as one in a chain identified with the licensor or manufacturer. Some states hold the view that if the franchisor’s commercial symbol enhances the franchisee’s chances of success, the trademark element will be satisfied. The use of a trademark or trade name in the healthcare environment may not be as pervasive as in a more traditional retail/franchise context. Therefore, there may be a degree of uncertainty whether the trademark element is met in certain circumstances. However, state interpretive opinions and court decisions have generally found the trademark element is present if the franchisee uses the franchisor’s mark in its dealings with the public.²⁰¹

A few of the laws, including the FTC Rule, require only that the franchisee be given the right to distribute goods or services which are “identified” by the franchisor’s trademark. Also, the failure to grant a franchisee the right to use a franchisor’s mark may not be sufficient to avoid satisfying the trademark element. The FTC has said that the trademark element will not be met only if a franchisor expressly prohibits the use of its mark.²⁰² In short, in many instances the trademark element will be met.

²⁰⁰ See text at Section I.C.2.a above and accompanying notes.

²⁰¹ *Liberty Sales Assoc., Inc. v. Dow Corning Corp.*, 816 F. Supp 1004 (C.D.N.J. 1993), Bus. Franchise Guide (CCH) ¶ 10,233; *U.S. v. Technical Communication Ind., Inc.*, 564 So. 2d 642 (Fla. App. 2 Dist. 1990), Bus. Franchise Guide (CCH) ¶ 9684; *Wright-Moore Corp. v. Ricoh Corp.*, *supra* note 51; *but see Bakke Chiropractic Clinic, S.C. v. Physicians Plus Insurance Corporation*, 573 N.W.2d 542 (Wis. Ct. App. 1997), (hereinafter “*Bakke*”), which found that in the context of an HMO (health maintenance organization), certain chiropractors did not have the right to use the mark of the HMO, and therefore, there was no franchise.

²⁰² Interpretive Guides, *supra* note 31.

As the discussion of the grant or trademark element above²⁰³ indicates, some state laws speak in terms of a grant to a person, the right to offer, sell or distribute goods. In certain the healthcare situations, the healthcare professionals may be affiliated with another organization or system, but that organization or affiliation did not and cannot grant the providers the right to offer and sell healthcare services. The professionals provide medical services independent of the affiliations. Therefore, depending upon the statutes being construed, the grantor of the marks, or the entity that arrange for the affiliation will not grant the healthcare professionals a right to sell or distribute products or services.²⁰⁴

b. Franchise Fee/Required Payment

Licensing fees and other payments made to the PPMC or to the licensor of the diagnostic services will likely satisfy the required payment element. Appropriate structuring of the business, financial, and legal relationships of the parties may, however, alter the analysis and conclusions.²⁰⁵ (Several other issues to consider when analyzing the legality of a healthcare arrangement, particularly when evaluating the revenue structure, include the prohibition against the corporate practice of medicine, anti-kickback provisions of the Medicare and Medicaid statutes (which may be implicated due to franchise fee payments), prohibitions against physician self-referral, and prohibitions against fee splitting. These subjects, however, are beyond the scope of this article.)

c. Control or Assistance/Marketing Plan

Satisfaction of the third element – the control or assistance/marketing plan – is often a close call. The healthcare model, unlike a restaurant or retail franchise, does not generally include comprehensive rules and requirements concerning the entire method of operation of a healthcare provider. In almost all cases, the healthcare organization that would be the putative franchisor will explicitly disclaim any control over the physician’s professional practice (owing to an avoidance of the corporate practice of medicine, or other reasons), and agreements will state that the physician may exercise his/her/its professional judgment in treating patients without interference. Also, many aspects of the control or assistance or marketing plan element, enumerated by the FTC or the states, are usually not present.

Nonetheless, in our examples, the healthcare provider or licensee must operate in accordance with a detailed operating manual prescribed by the PPMC or the licensor. Also, the physician’s employees may be required to attend training. Further, at least a modicum of marketing materials may be provided. Therefore, conducting a business in accordance with an operating manual and pursuant to a training program, coupled with the provision of marketing

²⁰³ See text at Section I.C.2.a and accompanying notes.

²⁰⁴ See, e.g., *Bakke; supra*, which held, independent of the court’s determination that there was no right to use the trademark, that the HMO did not grant the chiropractors the “right to sell,” nor the right to distribute goods or services. See also *Pollack v. Calimag*, 458 N.W. 2d 591 (Ct. App. 1990), Bus. Franchise Guide (CCH) ¶ 9659).

²⁰⁵ See discussion at III.B.3 above and accompanying notes regarding the flow of money and fees, from the consumer to the putative franchisor, and then to the putative franchisee, in an effort to avoid the “fee” element. Also, see discussion of joint ventures and partnerships at Section III.A. above.

materials, may, according to the FTC and several state laws, be sufficient to satisfy the control or assistance, marketing plan or system, or community of interest element. Furthermore, certain practice management and practice development services that may be provided to a physician or licensee may satisfy this third definitional element.

Healthcare providers may consider the franchise laws inapplicable to their business relationships, particularly where the control or assistance provided is not related to the “entire method of operation,” which is the language of the FTC Rule (if not the standard that is applied in FTC analyses or enforcement actions). For example, even though a PPMC may provide administrative services to a practice group, the services may not relate to the principal focus of the practice group—healthcare delivery and patient service. However, an FTC Staff Advisory Opinion²⁰⁶ that analyzed a license for health travel services granted to hospital systems and ambulatory care clinics found that the term “entire method of operation” is narrowly construed by the FTC staff. The FTC staff found that the entire method of operation must be viewed in the context of the business relationship entered into between the parties. Therefore, even if a new product or service is one of many products or services offered by a putative franchisee, if the putative franchisor's control relates to the new service or product, the control or assistance may be deemed sufficiently “significant” to satisfy the FTC Rule definition of a franchise.

2. *Exemptions*

Even though healthcare organizations or arrangements may fall within the coverage of one or more of the franchise laws, there may be exemptions from the pre-sale registration and/or disclosure requirements. The exemption most likely to be applicable to healthcare providers is the “fractional franchise” exemption.²⁰⁷ Certain healthcare arrangements, such as the license of a new diagnostic test or therapy, may satisfy the exemption. The applicability of the fractional franchise exemption depends upon individual circumstances. The FTC’s interpretive opinions concerning the fractional franchise exemption do not always provide comfort to putative franchisors that their business arrangements will be exempt from compliance with the FTC Rule. In 1997, the FTC staff reviewed an arrangement in which a system for providing a rehabilitative service for back problems was licensed to a sophisticated group of healthcare providers.²⁰⁸ The potential licensees fell into two classes: (a) hospitals, medical centers, and physical therapy clinics that previously offered physical therapy or rehabilitation services (for more than two years); and (b) healthcare entities that had been providing comprehensive health services (for more than two years) but did not offer physical therapy or rehabilitation services. After analyzing the basis for the fractional franchise exemption, the FTC staff held that while the exemption would be available as applied to the first class of prospective licensees, it would not be available for the second class. Consequently, not all healthcare providers will be considered “experienced” in connection with a many healthcare service or products. Also, the FTC staff noted that the exemption is not equivalent to a “sophisticated investor” exemption.

²⁰⁶ FTC Informal Staff Advisory Opinion 97-7 (August 18, 1997), Bus. Franchise Guide (CCH) ¶ 6487.

²⁰⁷ See discussion at Section III.C.1 above.

²⁰⁸ FTC Informal Staff Advisory Opinion 97-1 (1997), Bus. Franchise Guide (CCH) ¶ 6481.

3. *Business Opportunity*

A healthcare provider alliance, or, more likely, a new diagnostic service or therapy, could meet a definition of a business opportunity.²⁰⁹ The most likely grounds for an exclusion or exemption, however, is the exclusion for sales to existing businesses. Most business opportunity laws are triggered due to purchases of goods and services that enable a buyer to *start* a business.²¹⁰ Since most healthcare alliances, products or services will be targeted to existing physician groups or other providers, many of the business opportunities are likely to be inapplicable. Nonetheless, a careful analysis of each state law, and the proposed arrangement is prudent before entering into a new relationship.

4. *Summary*

It is generally recognized that franchise laws were designed primarily to regulate businesses different from healthcare providers. The franchise (and business opportunity) laws are quite broad, however, and, as a consequence, have far-reaching effects on many organizations and business arrangements. Also, as healthcare providers experiment with new models for marketing and distributing healthcare services, these organizations, and the arrangements created within the healthcare industry, are more likely to become ensnared in the broad sweep of the franchise laws.

B. Mobile Wireless Telecommunications

The telecommunications industry encompasses many technologies and a wide array of services that may be available to individuals and businesses. These technologies and services are available throughout the country (and globally). Many of these services are offered by entities that are licensed by the Federal Communications Commission (“FCC”) to provide service in a particular market. The ability to market services to customers who travel from one market to another, and to do so under a common name, may drive local telecommunications licensees to form alliances with each other. Depending upon the structure, the operational requirements, and the flow of money and fees, these alliances could be franchises.

1. *Mobile Telephone Services*

The mobile wireless industry is an industry in which alliances have been formed in the past, and may be formed in the future. Mobile wireless, generally, includes voice and data transmissions using a cellular architecture. Services include analog cellular phone service, paging services, digital cellular phone and data services, and PCS services that may include voice, data, Internet access, and instant messaging. Future services will include a range of data and video services. In the early days of cellular, the FCC, for the purpose of issuing cellular radio permits, divided the United States into more than 700 geographic regions, and issued two permits for each FCC region or market. One permit was referred to as the “A-side” permit, and

²⁰⁹ See discussion at Section II.A. above.

²¹⁰ *Id.*

one permit was referred to as the “B-side” permit. A-side permit holders operated on one set of radio frequencies (“A-band”), and B-side permit holders operated on another band (“B-band”). (The permit holders were sometimes referred to as “A-side licensees” or “B-side licensees.”) In an effort to develop economies of scale, and provide consistent service from one market to another, groups of A-side permit holders and groups B-side permit holders, formed alliances (with their like-band licensees) to market their cellular service in a variety of FCC geographic regions around the country. While some of these alliances developed relatively successfully (for example, CellularOne, an alliance of A-side licensees), other alliances were less successful in forging nationwide alliances with national brand recognition. Nonetheless, the model that was utilized, or could have been utilized with the cellular phone systems provides a framework to analyze other telecommunications alliances today and possibly in the future.

An example (based in part on actual experience of the cellular industry in 1990s) involves the creation of an alliance to operate geographically separate cellular systems under a single trade name. Assume that several of the larger companies that held multiple cellular licenses will form an entity and create a brand name. The alliance will seek to enlist other FCC permit holders (for example, other B-side licensees) to offer their services under one umbrella brand. The licensor could develop, and offer to each B-side licensee, the right to offer its cellular services under a designated brand or mark. In addition, each licensee will be required to comply with standards for the use of the mark in connection with advertising and promotion. The licensees must also comply with specified minimum standards of network quality and customer service, and provide certain core cellular telecommunications services to all customers. Each licensee will be required to submit to the licensor, for the licensor’s approval, samples of the licensee’s promotional and advertising materials. In order to ensure that the cellular service will be available to many customers in many locations, each licensee will be required to make its services available to “roaming customers” of other licensees if those customers are in the licensee’s territory. Each licensee of the cellular system will pay an initial license fee and annual renewal license fees to maintain its participation in the system. The great bulk of these fees will be utilized for nationwide advertising and promotional efforts.

Viewing this cellular telecommunications service model in the light of the franchise definition described earlier, it is quite clear that this model would fall within the franchise definition. First, the licensor clearly grants the use of the trademark. Second, each licensee must comply with service standards and other requirements imposed by the licensor, as well as participate in joint marketing efforts, thereby satisfying the control/assistance or marketing plan element. Third, the licensee is required to pay a fee. These types of alliances recognized that the provision of cellular telephone services under a single brand or mark, provided by independent FCC licensees could easily be considered as, and be treated as, a franchise relationship. The tacit or reluctant acknowledgment of a franchise relationship is, in essence, an acknowledgment that “franchising” is not simply a method of distributing goods and services such as cars, gasoline, hamburgers, tax preparation services or photocopiers. It may be applicable to a wide range of products and services, and hybrids of products and services.²¹¹

²¹¹ The sale and distribution of cellular telephones, and other requirements or devices is most likely to be subject to laws related to product distribution. See discussion at Section III.D above.

In this cellular telephone system model, the putative franchisor may assert that certain offers of “franchises” may be exempt from the franchise investment laws under a “large/experienced” or “blue chip” franchisor exemption.²¹² While the franchisor’s net worth or “size” requirement may be met, satisfaction of the “experience” requirement may be problematic, particularly if the technology is so new that neither the licensor nor the licensees will have five years of experience. The relatively few “sophisticated” franchisee exemptions²¹³ could be utilized to avoid the registration requirements in only a handful of states.²¹⁴ Nonetheless, the nature of this industry, with its requirement for a significant capital expenditure for operations, and the regulatory oversight by the FCC, would suggest that the protections under the franchise laws are not necessary for prospective franchisees. To the extent that the franchise relationship laws may apply with respect to issues of termination and non-renewal, each of these licensees would have, or should have, been sufficiently sophisticated to negotiate appropriate protections in the documents.²¹⁵ This business model is one, however, that is likely to receive a favorable review from state examiners by way of an application for discretionary exemptions.

Since the mid-1990s, however, there has been considerable consolidation of FCC license holders throughout the country. Consequently, the desire for, and/or utility of, nationwide alliances among smaller cellular license holders has lessened. That is not to say, however, that there are no “small” licensees. Some cellular licensees remain throughout the U.S. (and the FCC has issued other types of wireless licenses on a geographic market basis). These cellular license holders may wish to align themselves with larger carriers operating under a common nationwide mark. Also, nationwide cellular alliances may need the assistance of local carriers in certain markets to provide roaming and other services when their customers are in these local markets. To accommodate the needs and desires of small carriers and large systems, a variation on the franchise or affiliation model can be developed.

One variation involves the creation of roaming alliances. In this situation, the local FCC licensee will execute a roaming agreement with the national brand, in which the local licensee agrees to provide roaming services to the customers of the national brand, and other alliance members will provide roaming services to the customers of the local licensee. The local licensees may continue to operate under their existing brand name or another name. However, they are likely to be required to comply with certain operational standards of the nationwide alliance. The local licensees may have to comply with marketing standards, although it is unlikely that the licensee would be using the mark that is identified with the system. The roaming alliances can be structured so that local licensee pays no fees or other consideration to

²¹² See discussion of exemptions at Section III.C. above.

²¹³ *Id.*

²¹⁴ Notwithstanding the availability of some exemptions, in the 1990s, with close to 800 potential licensees, some operating in very small markets, not all potential licensees are, or would have been, sophisticated licensees or investors.

²¹⁵ As noted in conjunction with several other “accidental” franchises discussed in this paper, this business arrangement is likely to be offered only to existing businesses. Consequently, it is unlikely that any of the business opportunity laws would apply – either due to the “franchise” or “trademark” exemption, or because the FCC licensees were already in business, and most of the business opportunity laws pertain to the “sales” of goods and services to enable a purchaser to start a business. See discussion at Section II.A. above.

participate. Rather, the local licensee receives from the nationwide system a portion of the fees collected from the “roaming” customers. These roaming agreements may avoid franchise laws because the structure may operate in such a way that the local licensees would be receiving fees from the national carrier, based on revenue that the national carrier receives from its customers as it roams through the local licensee’s territory, and there may not be a fee paid by the local licensee to the national carrier. Also, if the local licensee is not offering services under the name or mark of the nationwide service, it is unlikely that the trademark element will be satisfied.²¹⁶

2. *Data Service Providers*

The mobile wireless industry has experienced, and continues to experience, technological developments. While cellular (analog or digital) voice services may not be ubiquitous, they are certainly well established throughout the country. The next wave of mobile wireless service is the transmission of data using mobile/cellular architecture. We are already beginning to see such services marketed with devices such as a wireless Palm Pilot or a Blackberry. While the number of carriers has decreased over time, with several large national operators controlling major markets, there currently exist the possibility of fragmented or balkanized data service providers throughout the country. These providers, and/or the FCC license holders, may see a need for, and potential benefits of, an alliance of data service providers throughout the country, operating under one name.

To explore this potential accidental franchise, assume that there has been a significant increase in the number of handheld wireless telecommunications devices, and that there are individuals who travel from city to city who are interested in dining at the top restaurants, and most popular restaurants, in each city. One or more of these cities may have a data service that compiles and provides to subscribers, restaurant reviews from the local print media. Such a service, while, useful in one city, may generate significantly more subscribers (and therefore more revenue) if it was available to subscribers in other cities, and if many cities were included in the database. A data service provider may develop this business in many cities, or might seek local affiliates to develop and market this service on a unified or national basis. This service, call it “Restaurants – Here and Now!” may be attractive to a mobile wireless provider as specific content to offer to its subscribers.

One can envision how this network of Restaurants – Here and Now! data services can satisfy the “franchise” definition under federal or state laws. The grant or trademark element is likely to be present. The fee element may not be so obvious, depending upon the flow of money and whether the local affiliates or licensees are required to pay any fees or contribute for any joint services. Will the local Restaurant – Here and Now! affiliate be required to pay a fee to participate in the nationwide service? Or will the flow of money be the opposite, and with the nationwide carrier paying a commission to the local licensee based on fees received from subscribers? The third element of a franchise – the marketing plan or control/assistance – is

²¹⁶ See *Price Technologies, Inc. v. Sun Microsystems Computer Corp.*, (N.D. Cal. 1994) Bus. Franchise Guide (CCH) ¶ 10,407 (unpublished); *Moodie v. School Book Fairs, Inc.*, 889 F.2d 739 (7th Cir. 1989), Bus. Franchise Guide (CCH) ¶ 9503; and *Fosdick Poultry Processors, Inc. v. Eager*, 555 N.E.2d 62 (Ill. App. Ct. 1990), Bus. Franchise Guide (CCH) ¶ 9638.

likely to be satisfied, but it, too, will depend on the business structure that is implemented. Will the local the local Restaurant – Here and Now! licensee be able to offer advertising and marketing services to local restaurants, hotels and other hospitality providers and if so will they be standard for such marketing and promotion? Will the local licensee be required to operate and compile its data services in accordance with standards established by the national entity? While the authors express no opinion as to whether this hypothetical Restaurants Here and Now! data service may or may not be a viable business, it highlights the issues raised in the accidental franchise analysis as applied to the mobile wireless telecommunications industry.

C. Insurance Agencies/Affiliations

Many industries or business relationships that accidentally may fall prey to the franchise laws are relatively sophisticated, or they may utilize new technologies, or involve parties that have the financial size and/or business experience that render the protections of the franchise laws unnecessary. The insurance industry, and insurance agencies in particular, may not fit within that description. Independent insurance agencies are illustrative of how a traditional, or long established, industry or business relationship may be, or become, subject to the franchise laws.

The insurance industry is quite large, in which different companies offer a wide array of insurance products and other financial products and services. Generally, the insurance companies issue and underwrite their policies. Insurance companies may have an employee sales force to promote or sell the products, or may enter into agreements with independent agents or agencies to do so. One class or group of agents, known as “general agents,” will often have the authority to promote the sale of the insurance company’s products, solicit orders and applications from potential customers, and provide certain information and service to the customers prior to and/or after the sale of the insurance policy. The “sale” of each policy is subject to the approval of the insurance company. In fact, the policy cannot be “sold” until the policy is underwritten and issued by the company, and the policy is paid for by the insured. The agent, generally, will not have the authority to bind the insurance company to any contract or policy. As will be discussed below, the limitation on the agent’s duties is critical in the analysis of whether a franchise exists.

The general agent will be authorized to hold itself out as an agent of the insurance company. The general agent will have the right to use the insurance company’s marks. In fact, the agent may have a contractual duty to identify itself as an agent of the insurance company, and use the marks as specified. In most situations, the general agent will not pay any initial fee or other consideration for the right to enter into this business. There are usually no ongoing fees, such as royalty or advertising fees. The principal source of funds, for both an insurance company and the agent is the customer’s or insured’s policy premiums. Payments are made directly to the insurance company. The insurance company will then pay a commission to the agent as compensation for his/her/its services.

Some insurance companies have been known to suggest, encourage, or even require their agents to purchase products or services to be utilized in or with their insurance agency, such as training services or other assistance regarding sales, marketing or recruiting. Agents have been

requested or required to purchase or obtain licenses for software that assists with these functions. In many cases, these products or services are obtained from a third party, not affiliated with the insurance company. Also, insurance companies may offer -- sometimes for free, or a nominal fee -- brochures, professional publications or other materials that an agent may utilize in the business.

The agent will be required to follow certain rules, standards and requirements of the insurance company. These may pertain to promoting the products, participation in insurance company-sponsored advertising programs, restrictions on customers or territories, record-keeping and reporting, and/or others.

The issue of whether an insurance agent is, or can be, a franchisee, has been raised in several jurisdictions.²¹⁷ In several cases from the past few years²¹⁸ the courts have determined that the relationship between the agent and the insurance company did not create a franchise.²¹⁹ The import of each decision lies in the analysis of the agent's rights or ability -- or lack thereof -- to "sell" the insurance products of the insurance company.²²⁰

In *Cawiezell*, the agent had the right to solicit and procure applications only. Franklin, the insurance company, had the sole right to accept or reject applications, and to make or amend policies. The court, in construing the Illinois Franchise Disclosure Act ("IFDA"), upheld the district court's determination that Cawiezell did not have the right to "sell or distribute" the insurance products.²²¹ Under the IFDA, a franchise must be "granted the right to engage in the business of offering, selling or distributing goods or services" The limitations on the agent's duty can easily be seen as not granting a right to "sell" or "distribute" products. The court also upheld the district court's ruling that Cawiezell had no right to "offer" the insurance products. By focusing on the definition of "offer" in Black's Law Dictionary and under the Restatement (2d) of Contracts, the district court and the court of appeals found that an "offer"

²¹⁷ See *Cawiezell v. Franklin Life Insurance Co.*, *supra* note 54 (hereinafter "*Cawiezell*"); *Stockton v. Sentry Insurance*, 989 S.W.2d 914, (Ark. 1999) Bus. Franchise Guide (CCH) ¶ 11,634 (hereinafter "*Stockton*"); *Keeny v. Kemper National Insurance Companies*, 960 F.Supp. 617, (E.D.N.Y. 1997) Bus. Franchise Guide (CCH) ¶ 11,172 (hereinafter "*Keeny*"); *Vitkauskas v. State Farm Mutual Automobile Co.*, 509 N.E.2d 1385, (Ill. App. 1987) Bus. Franchise Guide (CCH) ¶ 8899 (hereinafter "*Vitkauskas*").

²¹⁸ *Id.*

²¹⁹ An exception to this line of cases is *Cordova & Simonpietri Insurance Agency v. Crown American Insurance Company*, 112 DPR 797, 112 PRR 1003 (1982) (cited in *Lineas Aereas Costarricenses, S.A. v. Caribbean General, Inc.*, 682 F.Supp. 177 (DPR 1988), Bus. Franchise Guide (CCH) ¶ 9148), in which the Supreme Court of Puerto Rico held that because an insurance agent's commercial activity promotes and concludes in an insurance contract, an insurance agent is a dealer under the Puerto Rico Dealers' Contracts Law (Law 75).

²²⁰ In several cases, the court mentioned, or could have focused on, a real or apparent employer-employee relationship between the company and the agent. See *Stockton, supra.*; *Vitkauskas, supra.* This would have ended the franchise analysis because employees generally are not franchisees.

²²¹ *Cawiezell, supra.* The court said that the right to sell consists of an unqualified right to transfer a product at the point and moment of the agreement, and the agent did not have this right.

implies the right to enter into a contract if the offeree accepts the offer. Since the agent could not bind the insurance company, the agent did not have the right to “offer” insurance products.²²²

Several other cases have also focused on the limitations on an agent’s rights to sell insurance products or enter into insurance policies.²²³ While the more recent cases have taken this position, a few earlier cases have given credence to the argument that an insurance agency may be a franchise.²²⁴

If we were to adjust the facts and circumstances a bit, the argument that a franchise exists in the insurance agency context may become stronger. For example, if the general agent had the authority to enter into insurance contracts on behalf of the insurance company, the analysis under the “offer, sell or distribute” language may be different. In fact, there exist today insurance agencies, referred to in the industry as “managing general agents” (as opposed to “general agents”), who have the authority to underwrite policies, and/or enter into contracts, on behalf of the insurance company. The authors are not aware of any situations in which a managing general agent, with these rights and responsibilities, has claimed that it has entered into a franchise relationship. By permitting the agent to engage in activities that are, or more closely resemble, “selling,” an insurance company, arguably is granting the agent the right to sell or distribute the insurance company’s products. In addition, if the insurance company, through its agency agreements, procedures and standards manuals, marketing and promotional materials, or meetings with agents, utilizes words or phrases that strongly suggests that an agent is “offering” the insurance products on behalf of the company, a court might not feel so compelled to interpret the word “offer” as narrowly as did the court in *Cawiezell*.

Whether a managing general agent, or a general agent, were to assert that it entered into a franchise relationship, all three elements of a “franchise” must be satisfied. It is quite clear that the *marketing plan* element will be met in most cases. As discussed above, the *grant* or *trademark* element could be a high hurdle, but if cleared, the grant/trademark usage will be present. The *franchise fee* element, however, may not be present.²²⁵ As noted above, the principal revenue source are premiums paid by customers to the insurance company, and a portion of those premiums are paid by the insurance company, as commissions, to the agent.

²²² *Id.* Compare this decision to *Gentis*, discussed in Section I.C.2.a, and at notes 53 and 54 *supra*, in which the California court took an expansive view of “offer”, and held that even though a distributor lacked the authority to bind the principal, he was nonetheless engaged as a franchisee in “offering” the franchisor’s record-keeping systems and business products. The distributor was more than a mere “order taker” by soliciting new and existing customers, solving customer problems, providing ongoing support and service, and installing the principal’s products. Query whether the activities of the distributor in *Gentis* are more significant than those of an insurance agent in promoting, soliciting, and “offering” the insurance company’s products.

²²³ See *Stockton, supra*. In *Stockton*, the court was construing Arkansas Franchise Practices Act, which speaks in terms of “sell or distribute” goods. The court did not have to reach the analysis of whether the agent was granted the right “offer” insurance products.

²²⁴ See *Cordova supra* note 219; and see *Schlenker v. Farm Bureau Life Insurance Co.*, 1981 U.S. Dist. LEXIS 18618, Bus. Franchise Guide (CCH) ¶ 7840 (D. Minn. 1981).

²²⁵ See *Vitkauskas* in which the court said that the agent did not pay any franchise fee. The court in *Stockton* did not address this issue because the Arkansas statute construed in *Stockton* does not require a “fee” as part of the franchise definition.

Other payments may be required of the agent, but if these are made to third parties, the fee element will not be met. However, if an insurance company develops or acquires a sales or recruiting software program or other product, and sells or licenses that program or product to the agent, the fee element may be present.²²⁶ Furthermore, even nominal payments for brochures, publications, marketing materials may be considered franchise fees (in states that do not have an exclusion for certain minimum payments).²²⁷ Consequently, it is possible for agents to successfully argue that all these elements of a franchise are met, and that the agent is entitled to the protections of, or to enforce its rights under, a particular state's franchise law.

The agency relationship also may be subject to a state business opportunity law, if the definitional elements are satisfied.²²⁸ These include representations made by the seller (in this case the insurance company) to the buyer (in this case, the agent), a minimum payment by the agent (which, as discussed above in connection with franchises, may not be present), and the seller furnishing goods and services to the buyer to start (or in some cases, continue operating) a business. The nature of the insurance agency relationship may be less likely to be considered a business opportunity than a franchise, but it should not be discounted in all cases. Finally, the sales representatives laws²²⁹ may apply to these relationships.

In analyzing insurance agency relationships, and other agency relationships under the state franchise (and other) laws, each statute (and any regulations promulgated under the statute) must be reviewed carefully. In addition, several of the laws have express exemptions or exclusions for insurance agencies.²³⁰

As insurance companies modify their internal and external business models, slight variations could cause the agency relationship to cross the statutory line of a franchise. Or, courts may take a more liberal view of "offer" and find that an agent's promotion and solicitation activities constitute a right to "offer" products under the insurance company's marks. Insurance companies are not, however, the only businesses that enter into agency relationships for the purpose of promoting and/or selling products. Consequently, great care should be taken when structuring any such agency relationship. And, as noted earlier, with the diverse definitions of a franchise, the analysis of whether the structure is a franchise will vary from state to state.

²²⁶ See discussion of franchise fees at Section III.B. above.

²²⁷ *Id.*

²²⁸ See discussion at Section II.A. above.

²²⁹ See discussion at Section II.B. above.

²³⁰ *See, e.g.*, the Georgia Business Opportunity Law exclusion from its definition of business opportunity for an insurance agency, Ga. Code Ann. § 10-1-410(2)(B)(iv) (2000); the Nebraska Seller-Assisted Marketing Plan law does not include any transaction in which either the seller, purchase, lessor, or lessee is licensed pursuant to, and the transaction is governed by the Department of Insurance, Neb. Rev. Stat. § 59-1716 (2001); and the Wisconsin Fair Dealership Law does not apply to the insurance business, Wis. Stat. § 135.07 (2000). These exemptions should not be confused with exemptions under the franchise laws for franchise sales to banks, financial institutions, and, in some cases insurance companies. *See, e.g.*, Hawaii, Illinois and Washington.

D. Computer Industry and the Internet

1. Pre-Internet Age: Value-Added Dealers and Resellers

When the personal computer revolution took off in the early 1980s, manufacturers rushed to form distribution networks to get their hardware and software products into the marketplace. Manufacturers authorized independent dealers, distributors and re-sellers to provide approved “value-added” products and services to the manufacturer’s base hardware and sell computer components to designated customer’s classes. Value-added items might include the installation of approved peripheral hardware and private-label software, and after-sales customer training and product and warranty support. Manufacturers might specify technical configurations for dealers to use to distinguish the manufacturer’s computer product line.

A “close symbiotic relationship”²³¹ emerged between manufacturers and their independent dealer network, not unlike the franchise model. Dealers were strongly aligned, if not dedicated, to the hardware of a particular manufacturer and unlikely to resist shifts in manufacturer demands. Manufacturers required flexibility from dealers to adjust the network to constantly changing innovations, market demands and heightened competition. The parties’ contract was written to accommodate continual refinement through manual updates and dealer bulletins.

Performance quotas were imposed, as were spare parts inventory requirements. Dealers were often assigned specific product lines and confined to selling to end-user customers within a specific territory. Sales and marketing assistance was offered, in exchange for which dealers had to submit detailed sales, operating and customer reports. Product purchasing resulted in continual payments flowing from the dealer to the manufacturer.

Twice, computer software re-seller agreements have been held to be franchises, in *Current Technology Concepts, Inc. v. IRIE Enterprises, Inc.*²³² (Minnesota law) and *Instructional Systems, Inc., v. Computer Curriculum Corp.*²³³ (New Jersey law). In 1998, the FTC opined that a technology integration service business, which configured computer technology to fit specific customers’ needs, was a franchise since the promoter licensed others to use its advertising, marketing expertise and logos in their own marketing activities.²³⁴

The computer distribution channels that launched the personal computer revolution possess all of the trappings of a classic franchise. Notwithstanding that the industry did not even

²³¹ Brooks, *VADS, VARS, and Authorized Dealers -- Do the Franchise Laws Apply to the Computer Industry?*, Hastings Comm./Ent. J. Fall, 1989 at 35.

²³² 530 N.W. 2d 539 (Minn. S. Ct. 1995), Bus. Franchise Guide (CCH), ¶ 10,673.

²³³ 35 F. 3d 813 (3rd Cir. 1994), Bus. Franchise Guide (CCH), ¶ 10,527.

²³⁴ FTC Informal Staff Advisory Opinion 98-6 (August 12, 1998), Bus. Franchise Guide (CCH) ¶ 6495. The FTC determined that the arrangement probably qualified for the fractional franchise exemption. In 1995, however, the FTC opined that a distributorship involving the sale of software programs to medical providers was not a franchise because neither significant control nor significant assistance was present. FTC Informal Staff Advisory Opinion 95-1 (January 31, 1995), Bus. Franchise Guide (CCH) ¶ 6466.

exist when franchise laws were written, elastic legal definitions grab both traditional and emerging concepts. While the technology, itself, is certainly revolutionary, there is nothing remarkable about applying franchise laws to these pre-Internet dealer arrangements.

2. *The Internet Age*

No aspect of the computer revolution has captivated public attention like Internet technology. With its endless Web sites, the Internet has fundamentally altered how we interact and exchange information and sell goods and services. More than just an information and trade channel, however, the Internet is a springboard for a variety of new alliances that are potential accidental franchises.

Some Internet arrangements are, more or less, conventional bricks and mortar concepts extended to the virtual world. For example, agreements granting the right to sell Web space and Web advertising to customers in a designated area are the electronic equivalents of print advertising sales arrangements, which have been held to be franchises.²³⁵ In 1999, the FTC brought a successful enforcement action against iMall, an Internet consulting business and web host, for FTC Rule violations arising from the sale of two different business opportunities, one involving the sale of web pages on the promoter's e-commerce shopping site, and the other the sale of advertising space within the site. The promoter and its former principals agreed to pay a \$4 million penalty and accept a lifetime ban from selling Internet and pay-per-call business opportunities and a ten-year ban from selling franchises.²³⁶

As the computer platform shifts to web-based applications, new types of technology alliances are constantly being forged. Here is where today's accidental franchises may be lurking in the technology sector.

3. *E-Service and E-Training Arrangements*

The Internet has quickly become indispensable to individuals, businesses, institutions and governments as an everyday tool, not just to communicate and retrieve information, but to access innovative Internet-enabled applications which are forever being improved. The constant sea of technological change supports a new cottage industry: providing technical training to those whose job it is to service, and to teach others to maximize, these ever-changing technologies.

²³⁵ FTC Informal Staff Advisory Opinion issued to Travelhost Magazine, Inc., Bus. Franchise Guide (CCH) ¶ 6444 (March 2, 1989) (FTC opined that agreement granting right to distribute Travelhost Magazine and sell advertising in a designated area was a franchise).

²³⁶ *FTC v. iMall*, Bus. Franchise Guide (CCH) ¶ 11,624 (April 15, 1999). See also *FTC v. Inet International*, Bus. Franchise Guide (CCH) ¶ 11,659 (C.D. Cal. March 29, 1999) (marketing director of company promoting Internet access business opportunities permanently enjoined from selling franchises because of FTC Rule violations and false financial performance representations). However, in FTC Informal Staff Advisory Opinion 00-1 (January 20, 2000), Bus. Franchise Guide (CCH) ¶ 6505, the FTC opined that the relationship between a marketer of commercial web sites and independent commissioned sales agents selling advertising space on the marketer's sites was not a franchise because both the fee and substantial assistance/control elements were missing.

Bricks and mortar franchises offering computer training services to companies and individuals from fixed locations have existed for some time, launched in the 1980s by the computer revolution. The Internet, however, radically alters the traditional method for delivering training services.

Many companies have developed computer applications, which they offer to, or customize for, other businesses, enabling these businesses to train their employees off-site, wherever the employee may work, and often on demand, at times that the employee selects. Computer or Internet-enabled training models are being implemented by many leading franchise companies today.²³⁷

Additionally, developers of new software systems and applications realize the need to train technicians to provide their customers with support, not only in terms of helping to train the customers' employees, but in configuring their customers' own computer systems to interface with the developer's applications and in providing maintenance and troubleshooting services, all of which can also be delivered to customers entirely via the Internet.

Lacking any fixed location component, technology developers might assume that their arrangements with independent technicians are not a franchise. However, even entirely virtual e-distribution programs can qualify as franchises.

Consider this example: Education Z develops a model for training technicians on Internet-enabled applications and Internet equipment, such as Cisco-built routers (the Internet's backbone). Education Z has developed, and may own patents for, a software program that can be modified to simulate up to 200 different breakdown scenarios and that converts each snafu into a format that can be analyzed and manipulated on a computer screen, giving trainees a chance to practice resolving these scenarios in a simulated environment. Education Z brands its technology ("Z-labs" and "Z-training") and seeks out potential customers.

If Education Z offers its Z-training to end-users only, there might not be a connection to franchising. However, Education Z recognizes that large companies, dependent on the services of both employee-technicians and independent service representatives, are likely customers who may want this training. Further, training companies, already in the business of training others, may be interested in using and offering Education Z's programs.

Education Z develops a method to sell its branded online training by means of secure access to Education Z's website or extranet. Education Z is willing to offer large blocks of training time. That time can be used by purchasers or resold to others. Education Z now offers to Alpha, Beta, and Gamma, the opportunity to purchase, use, and "resell" Education Z's Z-training product and training time on Education Z's Internet based Z-lab.

Education Z is willing to authorize Alpha to market and sell the Z-training products and services. The Z-training products are offered under, or in conjunction with, Education Z's

²³⁷ Dina Berta, *Computer-Based Training Clicks With Franchisees and Their Employees*, Nation's Restaurant News, July 9, 2001, at 1, 18.

service mark. It would not be surprising for Education Z to seek to exploit this technology and service in the following manner:

- Education Z grants Alpha the right to use, sell, market, distribute and support Z-labs and Z-training products.
- Education Z may refer to Alpha as its licensee, dealer, or agent. Alpha may be permitted, or required, to market itself as an “authorized” dealer or provider of Z-training.
- Alpha may be required to pay an entry or initial fee.
- Alpha may be restricted as to the geographic region within which it may make sales calls to clients, and possibly also as to the number, or class, of potential customers to whom it may offer Z-branded training products or services.
- Alpha may be required to purchase training time (on Education Z’s system) for its employees and/or demonstration products.
- Alpha may be required to pay for computer time on Education Z’s website or extranet, which Alpha will resell to its customers.
- Education Z may provide marketing materials and literature, in tangible or electronic form, for use by Alpha to solicit new accounts and develop Alpha’s own market presence.
- Alpha may be required to develop a minimum number of potential leads or close a minimum number of sales each month or calendar quarter.
- Alpha may be prohibited from offering or selling competitive Internet-based training services.
- Education Z may grant Alpha the right to offer similar opportunities to others (such as a sub-dealership).

While the foregoing is not a typical bricks and mortar business, nor a typical Internet (or e-commerce) business, Internet-based training businesses may desire to expand and promote their products and services in this manner.²³⁸ A quick review of the elements of a franchise

²³⁸ If Education Z offered its Z-training or Z-labs from fixed locations, operated by independent owners, a franchise connection would be more evident. In fact, companies today that sell computer training services utilize franchising as a method of distribution. In the pre-Internet age, these companies may have depended on fixed locations owned by franchisees to offer and sell their software products and computer training services. More recently, these franchised networks may be able to provide an ethereal connection – via the Internet – to the source of their computer products and services, which may reside at the franchisor’s headquarters or the franchisor’s computer service center. Education Z, utilizing an entirely *virtual* distribution network, without
(footnote continued on next page)

indicate that, depending upon the particular facts of the distribution relationship, Education Z's distribution plan could be considered the offer of a franchise.

First, the trademark element may be present. Alpha, as a dealer, could be required to promote itself as an "authorized" Z-training business. In addition, Alpha may be required to use certain marks in its online promotions, on its website, and in communications with customers and potential customers. Further, it appears that Education Z may have granted Alpha the right to operate the business in substantial association with the marks and symbols of Education Z. The agreement is likely to contain words indicating a license to use the Education Z marks. Given these factors, the trademark element may be present.²³⁹ To avoid the trademark element, Alpha must be expressly and actively prohibited from using Education Z's marks, something which may conflict with Education Z's business objectives.²⁴⁰

Second, the fee element may be satisfied, as described above, if an initial fee is paid. Even if Education Z eliminates the initial fee, other payments or remuneration might satisfy the franchise fee definition. Obviously, a periodic royalty payment or advertising contribution is a fee. Even if these were not present, other payments might be made to trap Education Z. For example, payments for training, computer time for training, or demonstration products or programs could be fees.²⁴¹

If these various payments are eliminated, and the only payments by Alpha are for computer time to resell to its customers, Education Z might be able to avoid triggering the fee element of the franchise definition if Education Z can invoke the *bona fide* wholesale price exception.²⁴² As noted above, many traditional product distributorships are not franchises because the only payments that are made by the distributor are for products at *bona fide* wholesale prices which are bought for resale. Education Z's products are its computer time and training services. To the extent that Education Z's sale of these items can be classified as the sale of "products" at *bona fide* wholesale prices for resale, the franchise fee element may be avoided.²⁴³ However, the *bona fide* wholesale price exception under the FTC Rule and most state laws refers to merchandise, goods, or products, but not services.²⁴⁴ The extension of this exception to the sale and resale of services has never been judicially tested.

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any fixed locations, may mistakenly assume that its business model cannot be a franchise. However, with very few exceptions, the regulating jurisdictions do not define a franchise according to whether the franchisee has a fixed place of business in the state. Even these rules will likely be changed or reinterpreted as courts become more accustomed to dealing with the concept of personal jurisdiction arising from purely virtual transactions.

²³⁹ See *Colt Ind. Inc. v. Fidelco Pump & Compressor Corp.*, 844 F.2d 117 (3rd Cir. 1988), Bus. Franchise Guide (CCH) ¶ 9095.

²⁴⁰ See discussion at Section I.C.2.a and accompanying notes.

²⁴¹ See discussion at Sections I.C.2.c and III.B.2, and accompany notes.

²⁴² See discussion at Section III.B.1 and accompanying notes.

²⁴³ *Id.*

²⁴⁴ *Id.*

Lastly, the marketing plan or the control/assistance element is also likely to be satisfied. Depending on the jurisdiction involved, the existence of territorial or customer limits and the imposition of sales quotas may be enough to satisfy this element. Education Z will likely also impose training and operational standards. It may require participation in joint marketing efforts. At a minimum, Education Z will reserve the right to pre-screen and approve Alpha's own advertising. Therefore, many facets of the relationship could qualify as indicia of Education Z's marketing plan. Of course, under the FTC Rule, the control or assistance element must be significant and relate to the franchisee's entire business.²⁴⁵ If Z-products are just one of many training or online services offered by Alpha, or if Education Z's control relates only to the Z-training and Z-lab products, but not to any other functions or aspects of Alpha's business, Education Z's program may fall short of satisfying the federal franchise definition.²⁴⁶

4. ASPs

Another group of Internet-related service businesses that has developed with the increased use of the Internet are businesses that train users of ASP services, and sell or promote ASP services. An ASP – which stands for **A**pplication **S**ervice **P**rovider – is a technology company that develops software applications, hosts them from a centrally-managed website, and offers or leases these applications or services to customers. Applications that may be offered include payroll processing, data processing, employee benefits, marketing analysis and support, extranet creation, hosting and supporting chain management, distribution logistics support, training, and many others.

An ASP will design software applications that may be utilized by one, or many, customers, and will deliver these applications to its customers via the Internet. The ASP is an outsource for information technology products and services that a business may need. In short, an ASP is the Internet, or electronic, equivalent of the service bureaus that performed similar outsourcing functions a decade ago.

An ASP is able to offer its products and services nationwide, and globally, at or through one website or location. Franchising, with its many points of distribution, would seem to have very little in common with ASPs. Some ASPs have discovered, however, that they may need assistance in reaching out to potential customers. An ASP might rely on an employee sales force to market, promote, and distribute its service. Or, the ASP could enlist the services of independent businesses and agents. In either case, while the ASP's principal functions can be handled at its headquarters (or computer center), its customers in far-flung places may require frequent personal contact initially, to become acquainted with the full range of the ASP's products services, and on an ongoing basis, through continual support and training, in order to effectively and efficiently use the ASP's products and services.

²⁴⁵ FTC Rule, *supra* note 16.

²⁴⁶ Assuming Education Z's business model is a franchise, its purely virtual relationship with its distributors who deliver licensed services completely through the Internet raises interesting jurisdictional issues as to which state's and country's franchise laws apply to the relationship, especially if distributors are not confined geographically in providing licensed services.

Recognizing this need for a customer support and training force, or a sales force, ASPs seek out local technology companies and providers to provide this support. ASPs may refer to these entities as “partners,” “agents,” “representatives,” or by comparable designations. (For our purposes, we will call them agents.) ASPs may teach the agents about the ASP’s services: how to sell or market the services, train the customers and the customer’s employees to use the ASP’s services optimally, and provide periodic service and ongoing support. ASPs may require that the agent identify the ASP’s services, or the ASP, on the agent’s own website, in marketing brochures, on documents, letterhead or invoices, or even as co-branded logos on agent’s employees’ uniforms. In some cases, an ASP may permit, or require, the agent to refer to itself as an “authorized [ASP Name] representative.”

The ASP’s compensation from this arrangement, as well as the agent’s compensation, may be structured in various ways. The agent can sell the ASP’s products on behalf of the ASP. The customer’s payments can be made directly to the ASP, with the ASP paying a commission to the agent, or it can be made directly to the agent, who would, in turn, pay a percentage to the ASP and retain the difference as its compensation. If the agent provides post-sales support and training, the agent will most likely collect any service or training fees directly from the customer, but may have to remit a portion of the fees to the ASP. Some ASPs may be willing to forego payments from their agents of a portion of the agent’s support and training fees, recognizing that good customer service and well-trained customers will ultimately redound to the ASP’s benefit with future sales of new or ancillary products or services directly from the ASP.

The ASP might require that the agent promote the ASP’s products and services in a manner approved by the ASP, and require that agent-provided training conform to the ASP’s standards. The ASP may restrict the geographic area in which the agent may solicit and service customers, or may restrict the type or class of potential customers. There may be other aspects of an agent’s business that are subject to compliance with the ASP’s guidelines, although the pervasive operating controls typical of business format franchises may not be present.

As we have seen from several of the analyses above, the ASP-agent relationship may easily satisfy the three definitional elements of a franchise. If the ASP charges the agent a fee to become an authorized agent, the fee element is present. Also, any other payments for training, marketing, advertising support, materials, etc. may qualify as franchise fees. In most cases, the agent will not purchase the ASP’s products for resale, so the *bona fide* wholesale price exemption will not be available. Consequently, unless the arrangement is structured as a commission/agency relationship, with all payments by customers being made directly to the ASP, the franchise fee element is likely present.

As to the grant/trademark element, its presence will depend on the degree of association between the agent and the ASP’s marks. As discussed earlier, unless the association is truly minimal, or trademark use is flatly prohibited, the trademark element is likely satisfied.²⁴⁷

The marketing plan element, as has been noted above, is difficult to avoid since its presence depends on a subjective evaluation of various indicia. While many ASPs may not

²⁴⁷ See discussion at Section I.C.2.a and accompanying notes.

exercise significant control or provide significant assistance vis-à-vis the agent's *entire* operations, there may be sufficient controls or restrictions on the agent (*e.g.*, through territory and customer limitations) to satisfy this element. Under the companion community of interest definition, one may find a community of interest between the agent's efforts and the ASP's reputation and revenue.²⁴⁸

Thus, the ASP-agent arrangement described in this example may qualify as a franchise. If it does, the ASP may be able to avoid regulation by relying on the fractional franchise exemption.²⁴⁹ For example, as many distributors of branded products are multiple line distributors, the ASP's agents may offer training, support and marketing services for more than one ASP. Accordingly, depending upon the scope of each agent's business, the ASP may be able to minimize the regulatory burdens of being deemed a franchisor by taking advantage of the fractional franchise exemption under the FTC Rule and in a few state laws.²⁵⁰

If not properly structured, ASP-agent arrangements are another example of a lurking accidental franchise.²⁵¹ The arrangement may also qualify as a business opportunity if the fee element is satisfied and the facts show the ASP has made one of the triggering representations under these laws.²⁵²

The history of commerce over the Internet is limited and it appears to be rewritten virtually every month. Flexibility and change are the only constants. As businesses depend increasingly on the Internet to deliver new software applications, information and services, they gain feedback from their own efforts and from their customers on the marketing approaches that work best and yield the greatest results. That information drives businesses to experiment and refine their distribution models. Some distribution arrangements will be very similar to pre-Internet models, while others may be quite unique. The trick for businesses and counsel is to understand the fundamentals of today's franchise laws so that Internet distribution models can be optimally structured to avoid franchise regulation or to qualifying for an exemption or exclusion if possible.

²⁴⁸ See discussion at Section I.C.2.b above, and accompanying notes. An analysis of the existence (or not) of a franchise-specific investment, or the agent's reliance on the products or services of the ASP, may affect the determination of whether the community of interest element is met.

²⁴⁹ See discussion at Section III.C.1 above accompanying notes.

²⁵⁰ *Id.*

²⁵¹ Many companies offering services via the Internet, are, or may be considered, ASPs. Some have embraced – sometimes reluctantly – the franchise model for expansion and distribution. To the extent these ASPs have migrated from a distribution model that employs a more traditional, retail or distributor network, to one that utilizes the Internet, their systems may have developed as “intentional” and not “accidental” franchises. However, ASPs or ASP-support businesses not previously associated with a typical distribution or franchise network, are more likely to find themselves as accidental franchises.

²⁵² Two potential representations that might be made, or alleged, are (a) the ASP has provided accounts or leads for the agent's sales or training services, or (b) the ASP is providing marketing material. This analysis will be dependent on the facts and specific statutory definitions. See discussion at Section II.A above, and Appendix B.

5. Co-Branding Alliances

Technology alliances between unrelated companies are proliferating today largely because of an increasing dependence on outsourcing to accomplish strategic web-related development projects.²⁵³ Frequently, these alliances go beyond basic outsourcing, which is a vendor/vendee contract for specific services or products, and involve co-branding arrangements. Co-branding creates a level of interdependence enabling the party seeking outsourcing support to leverage its own brand by promoting its strategic association with the party supplying the needed technology services or products.

For example, numerous cross-linking agreements exist among web site owners that allow each site to display the other company's trademarks. In many cases, the virtual retailer pays the hosting site fees for web space and technical support and possibly a bounty for extra traffic driven to the retailer's own site.

Consider, for example, Amazon.com, which has strategic alliances with a variety of virtual retailers of consumer products, including ToysRUs and Drugstore.com. These virtual retailers buy web space and banner advertising on Amazon.com's highly trafficked web site and a cross-linking agreement, which enables Amazon.com site users to click through to the retailer's own web site and vice-versa. As a condition of cross-linking, Amazon.com, the dominant site, dictates the visual and functional requirements of the retailer's own web site, including requiring the retailer to display the Amazon.com logo prominently. Both parties bank on cross-linking to increase traffic to their respective sites.

In the Amazon.com example, a consumer who double-clicks the health & beauty tab at the top of Amazon.com's home page instantaneously and invisibly is brought to Drugstore.com's web site. Drugstore.com's home page prominently displays the identical Amazon.com style tab cards and the banner, "Amazon.com, Health & Beauty by our Trusted Partner," reinforcing the Amazon.com-Drugstore.com affiliation. Similarly, a consumer who double clicks the toys&games tab at the top of Amazon.com's home page instantaneously and invisibly is brought

²⁵³ Chase.com Goes Global, *Information week* July 24, 2000, discusses how Chase Manhattan Bank abandoned its practice of owning and controlling all essential technology applications and outsourced these functions to an independent ASP to overcome a "chronic shortage of IT talent and an aggressive deadline to roll out online customer-service options."

Outsourcing is particularly valuable in the high-tech world where there is constant pressure to integrate the latest in a constant stream of technological innovations. Ironically, franchising's chief benefit is that it enables companies to expand by leveraging two essential ingredients for growth: talented personnel and capital. See Norman D. Axelrad, & Lewis G. Rudnick, *Franchising: a planning and sales compliance guide* at 81 (CCH, 1987). Instead of investing in traditional infrastructure and employee talent, franchisors rely on independent franchisees. Conceptually, outsourcing and franchising share common objectives.

Strategic alliances among competitors have surged since the mid-1980s. Economic globalization and the advance of knowledge-based industries, like high-tech, telecommunications, bio-tech, and financial services, are compelling competitors to forge cooperative alliances to enable each to react more quickly to innovative changes. Stephen Chen, in *A New Paradigm for Knowledge-Based Competition*, Technology Analysis & Strategic Management, December, 1997, reports on studies that show that competitors that forge strategic alliances are each more likely to be successful than firms adopting exclusively cooperative or exclusively competitive strategies.

to the ToysRUs web site, which likewise displays the identical Amazon.com style tab cards and Amazon.com logo. In addition to displaying Amazon.com's logo on their own home pages, visually, each retailer's site mimics distinctive design elements of Amazon.com's site, including the distinctive tab cards to organize product categories and the identical placement and style of search and browsing directories.

Consumers who access these virtual retailers' own sites directly, or through the Amazon.com site, are unlikely to know where in the virtual world they are shopping because all bear Amazon.com's distinctive branding. In view of Amazon.com's marketing controls, are these cross-linking alliances sufficiently symbiotic to be a franchise?

Also consider web hosting arrangements, like that between AOL and CBS/SportsLine, the latter supplying AOL with much of its sports content through a distribution agreement.²⁵⁴ Out of the alliance, SportsLine gets cash and cross-promotion visibility, and AOL secures continual sports content that drives traffic to its web site. The mutually beneficial, interdependent arrangement among sophisticated parties makes it difficult to identify the dominant licensor in a classic franchise sense. Yet, overall, the relationship embodies association with another's trademark, marketing-type controls, and a fee, the definitional elements of a franchise.

Our technology-driven business economy is a fertile environment for these constantly unfolding alliances. Lurking among them may be the next accidental franchise.²⁵⁵

E. The Relationship Between Television Networks and Affiliate Stations

A television network's logo proudly displayed by local affiliate stations pursuant to a station affiliation agreement emblemizes a commercial arrangement which falls beneath the franchise radar, but which potentially satisfies the classic franchise definition. Even though network-affiliation relationships are highly regulated by the FCC, franchise laws recognize no exemption for the telecommunications industry.

²⁵⁴ Terry Lefton, *NFL Signs Its Own Big 3*, The Industry Standard,.com, July 11, 2001. The article reports that "AOL gets much of its sports content through a distribution agreement with SportsLine."

²⁵⁵ Consider this press release appearing in the March 8, 2001 Telecomworldwire: The "specialist distributor," Sequoia Industrial Systems Division, introducing the latest technological storage system supporting ASPs signed a *franchise agreement* with Ciprico, a US-based developer of direct-attached and networked storage systems.

This discussion is intended to raise a level of awareness that technology alliances possess the characteristics of a franchise. However, conceptual challenges exist. For example, in the AOL example: are AOL's visual and functional controls materially different than those that a newspaper might impose on a print advertiser?

Even if technology alliances are franchises, they might not satisfy all of the various definitional models. For example, the alliances might more easily satisfy a franchise definition requiring substantial assistance or control than the community of interest standard, which requires a dealer to show a sufficiently large stake in the relationship to make the grantor's power to terminate, cancel or not renew a threat to the dealer's economic health. See *Lakefield Telephone Co. v. Northern Telecom, Inc.*, 970 F.2d 386, 389 (7th Cir. 1992) (finding no community of interest in the relationship between a manufacturer of telephone interconnect systems and an independent rural telephone company).

First, networks grant their local affiliate stations the right to offer, sell or distribute their television programming. This satisfies the statutory element of a right to distribute services.

Second, a network most likely prescribes a marketing plan under which the local affiliate must broadcast and distribute the network's programming or provides significant assistance of control in connection with the affiliate's broadcasting activities. As noted in Section I.C.2.b., the marketing plan definitional element is highly non-specific. For example, a network may provide local stations with detailed instructions addressing a myriad of issues, ranging from programming to promotion and sale of commercial airtime to local advertisers. Networks may limit the affiliate's programming discretion, use of primetime airtime slots, use of network logos and trademarks, and sale of commercial airtime to local advertisers which compete with the network's national advertisers. The network may conduct periodic regional sales meetings to instruct stations on approaches for selling commercial airtime during network programming and to enable local affiliates to share ideas and engage in collective marketing programs.

The network may establish promotional co-op advertising plans for each affiliate that contain directions and strategies for promoting network programming and purchasing local advertising buys. The network may target how much the affiliate should, or must, spend during specified intervals on local advertising to promote network programming. It may maintain strict criteria on the kinds of local advertising that qualify for co-op benefits, and may produce advertising spots and supply each station with materials which the station must air in their own markets.

The offer, sale and distribution of network programming by an affiliate station will be substantially associated with the network's marks and symbols. The affiliate will likely use the network logo on letterhead, signage and in communications with advertisers. It will communicate its association with the network to its viewers (consider the NBC peacock that is displayed by all local affiliates nationwide). In some cases, the network may insist that affiliate stations drop their call letters and simply adopt the network's name followed by their station number. The network may provide the affiliate with artwork incorporating the network's trademarks and logos. These requirements will result in a unifying trade style that emphasizes each affiliate's association with the network.

Lastly, the required franchise fee will be present in a number of different payments. Even if no up-front affiliation fee is charged, affiliates may be obligated to assign a portion of their local cable revenue to the network (re-transmission commissions). Payments for promotional merchandise, if required, would also constitute franchise fees.

The local affiliate may also be required to relinquish or assign to the network commercial time slots during primetime programming to enable the network to sell the slots to its national advertising accounts. By accommodating the network, the affiliate, in essence, makes a payment to the network in the form of broadcast time. Since broadcast time has a ready market, as reflected in the price which national advertisers pay the network for the commercial slots, an argument can be made that mandatory release of commercial air time to the networks, which is

the essential *quid pro quo* for receiving the network's programs, is, at a minimum, an indirect franchise fee.²⁵⁶

While the extension of franchise laws to a television network's relationship with its local affiliate has never been discussed in any reported judicial or regulatory opinion or secondary authority to our knowledge, two California Commissioner opinions have applied the California franchise laws to specific entertainment industry arrangements.

In Commissioner Opinion No. 71-42F, a license agreement between a television production company and a television station was held not to be a franchise. The producer supplied the station with prizes in return either for cash or broadcasting time, but the Commissioner found the supply service was optional.²⁵⁷ Overall, the Commissioner found the relationship lacked a marketing plan.

However, in Commissioner Opinion No. 74-12F, a license agreement between a motion picture production company and a distributor was held to be a franchise. Here, the distributor/licensee was required to pay a one-time fee for the distribution rights.²⁵⁸

An affiliate station's sophistication and high net worth may eclipse the attention of franchise regulators since franchise laws were originally devised to protect mom and pop business owners.²⁵⁹ Nevertheless, television affiliation arrangements bear all the markings of a franchise. The same analysis applies to arrangements between radio networks and their local affiliates.

In many respects, network-affiliate station relationships are not unlike arrangements between sports leagues and their individual team members. Like the network affiliate-station relationship, member teams substantially associate themselves, and are subject to overarching marketing rules imposed by, the league as a condition of league membership.

²⁵⁶ Networks may argue that a franchise fee is confined to a payment in currency. If affiliate stations make no payment to the network other than relinquishing commercial time slots, networks may argue that there is no franchise fee since no money changes hands. See *Communications Maintenance v. Motorola, Inc.*, 761 F.2d 1202, 1206 (7th Cir. 1985), Bus. Franchise Guide (CCH) ¶ 8359 (equipment dealer's cost to perform mandatory installation and service work for customers was not a franchise fee because the promise to perform future services did not accord with the normal meanings of "fee" and "pay," terms used to define "franchise fee" under the Illinois franchise statute). *Communications Maintenance* was followed by *Implement Service, Inc.*, *supra* note 85. On the position that a franchise fee is confined to money payments, see *supra* note 148 (FTC informal opinion that contribution of sweat equity did not constitute payment of a franchise fee) and *Upper Midwest Sales v. Ecolab*, *supra* note 84.

²⁵⁷ California Comm'r Op. 71/42F (July 27, 1971) 1971 Cal. Sec. LEXIS 107.

²⁵⁸ California Comm'r Op. 74/12F (Nov. 14, 1974).

²⁵⁹ Proposed amendments to the FTC Rule would add a sophisticated franchisee exemption. FTC NPR *supra* note 18 at 57320. At the moment, only California, Illinois, Maryland, Rhode Island, Washington and Wisconsin have sophisticated franchisee exemptions. A sophisticated franchisee exemption would remove most network affiliation arrangements from the reach of franchise laws. However, the addition of a federal exemption will not preempt states from regulating these arrangements as franchises.

Indeed, the relationship between professional sports associations and their team members may be one of the most visible accidental franchises staring us in the face today.

While the connection between professional sports and franchising is informally made all the time through the common, colloquial and non-legalistic use of the term *franchise* to refer to a sports team, at least one court has also made the connection legalistically. In *Continental Basketball Association v. Ellenstein Enterprises, Inc.*,²⁶⁰ an Indiana appellate court held that the Continental Basketball Association (CBA) was a franchisor under the Indiana franchise law by granting an Evansville, Indiana club the right to distribute professional basketball services under a prescribed marketing plan substantially associated with the CBA's logos, in exchange for which the club paid a fee. The court found that the fee was paid not just for the use of players under contract with the CBA, but for the right to participate in the league.

No other professional sports league to our knowledge seems to have paid any attention to this lone state court ruling, but the ruling's logic appears applicable. This is so even if sophisticated, multi-million dollar professional sports teams seem an unlikely subject for today's franchise laws. Such is the case with most of the accidental franchises described in this article.

F. Airlines and Regional Carriers

As national airline carriers have shifted to hub-and-spoke delivery systems, they have formed alliances with local carriers to provide commuter service from their hub centers. Examples include the alliance relationships between Delta Airlines and Skywest,²⁶¹ United and Air Wisconsin,²⁶² United and Delta and Atlantic Coast Airlines,²⁶³ and Northwest and Northwest Airlin.²⁶⁴ At the heart of these arrangements is a license permitting the independent local

²⁶⁰ 640 N.E. 2d 705 (Ind. Ct. App. 1994), *Bus. Franchise Guide* (CCH) ¶ 10,541, *aff'd* 669 N.E. 2d 134 (Ind. 1996).

²⁶¹ *See generally*, Paruna Patel, Top 100 Regional Airline Director, *Airline Business*, May, 2001 at 67. Delta owns a 13% stake in Skywest and is Skywest's largest shareholder. This might at first suggest that these relationships are not between true independents in the classic franchise sense. In fact, it fits Illustration 4, discussed earlier in this Section.

Delta also had alliances with Comair and Atlantic Southeast Airlines until acquiring its local feeders to the consternation of Delta pilots. Richard Pinkham, How Does Your Airline Grow, *Airline Business*, May, 2001 at 48. Other articles note that low-cost regional carriers have been gobbled up by network giants, condemning antitrust regulators for turning the other cheek. Paruna Patel, Fair Game? *Airline Business*, June 4, 2001 at 9

²⁶² Air Wisconsin is privately owned.

²⁶³ Atlantic Coast is publicly held, but neither Delta nor United Airlines appears as a shareholder on the company's public records.

²⁶⁴ Northwest owns 33% of Mesaba *dba* Northwest Airlin. There are many more examples of independent alliances between national and regional carriers outside of the United States, where the term *franchise* is broadly used to describe a variety of codesharing arrangements. *See* the Patel article, *supra* note 261. In a kind of "six degrees of separation" marketing approach, airlines vie for market share by promoting their global, one-world alliance partnerships in an effort to expand their geographic reach and control passengers. Kevin O'Toole, A Question of Maturity, *Airline Business*, May 2001, at 88.

carrier to associate itself with the national carrier's trademarks.²⁶⁵ The question arises: is this license really a franchise?

The question was addressed in *In Re Northeast Express Regional Airlines, Inc.*²⁶⁶. Looking to strengthen its jet capacity at Boston's Logan Airport, Northwest Airlines entered into an Airline Service Agreement ("ASA") with two different regional carriers allowing each to identify their commuter airlines as "Northwest AirlinK" and adopt Northwest's designation code, colors and logo. Northwest charged each carrier a \$10.00 fee per flight in and out of Logan, and paid the carriers a portion of its ticket revenue for the Northwest passengers they flew. After the regional carriers ran into financial difficulties, Northwest notified the carriers that the ASAs would terminate in six months, whereupon the carriers commenced separate bankruptcy proceedings to stay the terminations. Shortly thereafter, the common bankruptcy trustee initiated this adversary action seeking damages against Northwest Airlines for, among other things, violation of the Minnesota Franchise Act. The issue came down to whether the carriers paid Northwest Airlines a franchise fee.

The court quickly disposed of the carriers' first argument -- that the bank fees that they paid to maintain a required letter of credit constituted indirect franchise fees. The court held that the bank charges were not franchise fees because the carriers did not pay the charges to Northwest Airlines. The court had more difficulty with the carriers' second argument, which was based on the \$10.00 per flight fee which they were required to, and did, pay to Northwest Airlines each time they flew in and out of Logan Airport. Without logical explanation, the court refused to find these payments were made as a condition of a franchise, and attempted to distinguish them by finding that the fees were in exchange for Northwest providing ground handling and related services. While quoting Minnesota's statutory definition of a franchise fee, which includes "any payment for goods or services," the court appeared overly reluctant to extend the Minnesota franchise law into uncharted territory, *i.e.*, the airline industry.²⁶⁷ The court expressed its reluctance this way: "the trustee cites to no case where an airline services agreement has been found to constitute a franchise agreement and we are unable to find one."²⁶⁸ Given the *Northwest* court's ready dismissal of the carriers' franchise claim, it is difficult to reconcile the outcome with other decisions like *To-Am v. Mitsubishi*,²⁶⁹ which take a far more sweeping approach to the franchise fee definition.

²⁶⁵ As small commercial jet designs improved during the last decade, independent regional airlines emerged as real contenders for market share, no longer small-scale feeders flying little turboprops. The regional carriers' goal has been to leverage their lower-cost infrastructures and compete with national carriers for local routes, offering better prices and "giving consumers held captive to the local fortress hub a vehicle to escape hub fares." The major carriers have fought competition from their alliance partners in a number of ways, not only by gobbling them up, but by challenging regional pilot pay scales and imposing scope clauses restricting the fleet size and distances that regional carriers may fly. Richard Pinkham, How Does Your Airline Grow, *Airline Business*, May, 2001 at 48. These controls are akin to marketing controls.

²⁶⁶ 228 B.R. 53, 1998 Bankr. LEXIS 1659, 33 Bankr. Ct. Dec. 813 (Bkrcty. D. Me 1998).

²⁶⁷ *Id.*

²⁶⁸ *Id.*

²⁶⁹ *Supra* note 163.

The outcome in *Northwest* fails to square with the considerable body of authority finding a franchise fee under facts far less obvious than those before the *Northwest* court. It conflicts with Minnesota's statutory franchise fee definition, the liberal approach which courts are directed to apply in interpreting consumer statutes, and, plainly, is wrong.

Minnesota legislators were undoubtedly aware of the *Northwest* case as it was working its way through the courts, aware that the Minnesota franchise definition could indeed capture air carrier alliances. In 1998, the legislature amended the Minnesota franchise statute to expressly exclude from the franchise definition "a contract, lease, or other agreement or arrangement between two or more air carriers."²⁷⁰ The legislature made the new exclusion effective retroactive to May 31, 1997, but specifically excluded from retroactivity any agreements or arrangements subject to pending litigation on the enactment date alleging the relationship was a franchise.²⁷¹

What is surprising is not the Minnesota legislature's deliberate reaction to the *Northwest* case, but the fact that the franchise specter had never before been considered by any jurisdiction in the context of air carrier relationships. Nor, to our knowledge, has the connection been made since, as Minnesota's exclusion remains unique. Airline industry business publications, however, continue to use the term *franchise* freely to describe alliances between national and regional carriers, undoubtedly unaware of the legal entanglements the term can carry.²⁷²

Northwest should not mislead practitioners: air carrier alliances bear all the trappings of a franchise. Code sharing arrangements, reservation services, aircraft maintenance requirements, minimum service criteria, and marketing requirements all support the grant of service distribution rights under a prescribed marketing plan, community of interest, or in connection with the grantor's substantial assistance or control. Trademark affiliation arises from the local carrier's right to display the national carrier's logo in advertising and customer reservation services, and from the national carrier's promotion of its alliances with regional commuter links. The fee element exists in charges like the flight fees collected by Northwest or in less obvious payments that qualify as indirect franchise fees. And some alliances may require payment of up-front affiliation fees.²⁷³

²⁷⁰ 1998 Minn. Sess. Law Serv. C. 353 amended § 80C.01, Subd. 4(h) to add the air carrier exclusion effective retroactive to May 31, 1997, except in the case of agreements subject to pending litigation as discussed in the text.

²⁷¹ The 1998 amendment specifies that the "nonapplicability of [the new air carrier exclusion] to those agreements or arrangements subject to litigation pending on the date of enactment shall not evidence any intent nor be construed to mean that they would or would not otherwise constitute a franchise within the meaning of Minnesota Statutes, section 80C.01, subdivision 4."

²⁷² See, e.g., Gunter Endres, Progress Unchecked, *Airline Business*, May, 2001, at 50, discussing the world's top 100 regional airlines and observing that "one of the more significant aspects of the list is the fact that all but a handful of the top 100 airlines are affiliated, through equity involvement, *franchising* or important codeshares, with major airlines." [Emphasis added]

²⁷³ A public database describes Atlantic Coast's relationship with United, for which it flies certain Eastern and Midwestern U.S. routes as United Express, and with Delta, for which it flies certain Eastern U.S. routes as Delta Connection. The description does not mention any specific fees that the regional carrier has paid, or must pay, to the national carriers. It does, however, mention that United and Delta each pay the regional carrier fees under
(footnote continued on next page)

Outside of Minnesota, there does not appear to be any statutory basis or legal rationale for denying regional airlines, highly sophisticated businesses, the full panoply of franchisee protections notwithstanding that these laws were written with unsophisticated mom and pop small business owners in mind.

V. RETHINKING CURRENT FRANCHISE LAWS IN AN EVER INCREASING BRAND CONSCIOUS WORLD

It is well documented that brand name awareness highly influences consumer choices. Recognized names offer a *halo* effect. If it's a *better-known* brand, the common perception is that it's a *better* brand. Brands breed comfort and familiarity. A hamburger chain enhances its own menu items by serving Heinz ketchup and Gray Poupon mustard instead of the same condiments in a generic dispenser. Brand association encourages consumers to believe that the establishment can be trusted to offer better quality products and services.

Given the increasing influence of brands in purchasing decisions, it is no surprise that investors look to improve their competitive positions by affiliating with brand owners. While these affiliations may not always be formalized in a licensing agreement, nevertheless, money often is paid for the right to use another's trademark and controls typically are imposed to protect the mark from misuse and dilution. With that nexus, the cornerstone of a franchise is laid.²⁷⁴

Legislators may not have understood the psychology behind branding 30 years ago when they wrote today's franchise laws. The fundamentals of franchise regulation were devised at a time when brands played a less significant role in consumer choices, when our nation was smaller, transportation and communication systems less sophisticated, and regional tastes and preferences more distinct.

Perhaps modern franchising's progenitors had a vision of branding's power half a century ago when they built their empires on the backs of their brands. For everyone else, the enormity of the branding factor has only recently come into focus. The preoccupation of business consultants, marketing specialists, psychologists and academics with the branding phenomena has, itself, intensified both a branding frenzy, and, in some respects, a branding backlash, a push towards customization. Today, however, everyone accepts, and expects, brands to dominate consumer choices and influence market share.

Society's preoccupation with branding is the single greatest reason so many accidental franchises exist. But, the connection between the branding phenomena and franchising is not accidental. The connection arises not just because the trademark controls that accompany

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two different schemes, one based on departures and the other based on flying time. It is entirely possible that the arrangements have been deliberately structured to avoid the required fee element found in most franchise definitions. Copyright 2001 Disclosure Incorporated, All Rights Reserved., Atlantic Coast Airlines Holdings Inc., Disclo Company Number: A873315000, LEXIS, Company Information Library.

²⁷⁴ *Susser v. Carvel Corp.*, 332 F.2d 505, 516-17 (2nd Cir. 1964), *cert. denied*, 381 U.S. 125 (1965).

branding arrangements resemble marketing controls characteristic of a franchise. Branding arrangements offer companies new sources of revenue.²⁷⁵ With consumers' insatiable appetite for brands, trademark owners see an opportunity to leverage an asset – their brand – by forming symbiotic relationships and thereby multiply sales of their branded products and services. Thus, brands not only build businesses, they enable companies to launch networks.

It is doubtful that the original franchise law drafters would have devised a regulatory scheme as potentially far-reaching as the one they gave us had they gotten started in today's economy, knowing what we do about the psychology of branding. Or at least they would have devised a less burdensome system, one that excludes sophisticated investors from the same intricate protections afforded mom and pop businesses, and one that better articulates the distinction between non-franchise licenses and distribution programs, on the one hand, and franchises, on the other hand.

In summary, franchising is fast becoming ubiquitous because branding is becoming ubiquitous. There is a great need to reexamine the reach of franchise laws in light of the dominance of brands in our economy.

VI. CONCLUSION

Counsel should think franchise whenever there is a trademark license. The trademark license should be a tip to examine whether consideration is being paid, directly or indirectly, to the grantor for the right to associate with the grantor's trademarks.

Certain aspects of the franchise definition, like the marketing plan, community of interest, and substantial assistance and control elements, are quite imprecise making it difficult to render an opinion to a client that an arrangement does not contain at least some of the indicia of those definitional elements.

Counsel should never assume that the terminology used to describe a relationship, or joint venturing with an investor, will shield the relationship from regulation. While labeling the parties as something other than "franchisor" and "franchisee" and adding a disclaimer that the agreement does not create a franchise relationship, will not defeat franchise status, the contract drafter is not without some tools. To the extent that a contract is deliberately structured to avoid a franchise definitional element or to take advantage of a statutory exemption or exclusion, the contract should contain statements (in the contract recitals or acknowledgments) that express these facts. While self-serving statements like these do not guaranty that the relationship will not be challenged if the statements are accurate, they can help a company rebut the challenge.

The regulatory burdens of being deemed a franchisor must, however, be kept in perspective. Numerous franchisors operating in the United States comply with the franchise laws every day, and sustain and grow successful and viable businesses. Franchise avoidance

²⁷⁵ For example, see the article in the May/June 2001 issue of *Franchising World* entitled "Sears To Leverage Famous Name," at 61, describing how the leading retailer "hopes to leverage its household name into a fast-growing franchising concept -- Sears Carpet & Upholstery Care."

techniques are not achieved without a cost, and those costs may be more painful than franchise law compliance. In short, companies are foolish if the desire to avoid legal regulation as a franchise drives their decisions on how to structure their distribution relationships.

The consequences of being deemed a franchise are substantial for the putative franchisor or putative franchisee. Used as a sword, enforcement of franchise laws can give rise to severe legal remedies including damages and rescission of the arrangement. Rescission, in particular, is a potent weapon for a franchisee with a failing business, even more so for a franchisee in a failing chain. Franchise laws impose joint and several personal liability on the franchisor's executives and sales agents, as well as criminal penalties.

As a shield, identification as a franchise can prevent, or confer remedies for, the termination or nonrenewal of a business relationship without *good cause*. There are other possible consequences of being classified a franchise (whether traditional, non-traditional, accidental or otherwise unintended), including far-reaching substantive laws in some jurisdictions, more litigation and possible class action suits, and collective bargaining by organized franchisee associations.

While structural solutions may save some commercial relationships from the reach of franchise laws, often these solutions come at the price of sacrificing essential marketing concepts or economic objectives. Understanding the broad reach of franchise laws is the best insurance against the accidental franchise.

APPENDICES

Appendix A: Franchise Disclosure Law Exemptions and Exclusions

Appendix B: Business Opportunity Law Definitions

Appendix C: Business Opportunity Exclusions

APPENDIX A

**FRANCHISE DISCLOSURE LAW
EXEMPTIONS OR EXCLUSIONS**

(As of April 28, 2001)

JURISDICTION	FRACTIONAL FRANCHISE	RETAILER LICENSE	EMPLOYEES	GENERAL PARTNERSHIPS	COOPS	CERTIFICATION MARKS	SINGLE LICENSE	LARGE FRANCHISOR	SOPHISTICATED PURCHASER/EXPERIENCED FRANCHISEE	ISOLATED OR LIMITED SALES	SALE BY FRANCHISEE	OUT OF STATE SALES	PETROLEUM WHOLESALERS	SALES BY EXECUTOR, TRUSTEE, ETC.	BANK CREDIT CARD PLAN	BANKS	MOTOR VEHICLES	RENEWAL W/O CHANGE	SALE TO EXISTING FRANCHISEE	OTHER
FTC	X	X	X	X	X	X	X													
CA	X				X			X	X		X	X	X		X					
HI										X	X			X		X	X	X	X	X
IL	X	X				X		R	R	R	X					X				R
IN	X							X		X	X									R
MD								R	R		X	R		X		R			X	
MI	X	X			X					X	X			X		X		X	X	X
MN	X	X								X	X	X		X		X	X			X
NY								X		X	X					X				R
ND								X			X									
OR	R	R	R	R	R	R	R				R							R	R	R
RI		X						X	X		X	X		X				X	X	X
SD		X						X			X			X		X				X
VA	X	X																		
WA								X	X		X			X		X			X	X
WI	X				X				X		X	R				R			R	XR

Code: "X" is statutory exemption. "R" is regulatory exemption.

Note: Some exemptions or exclusions avoid the need to comply with both the disclosure and registration obligations under the franchise laws. Others may only avoid the need to register or go through the state review process.

APPENDIX B

BUSINESS OPPORTUNITY LAW DEFINITIONS

DEFINITION	AL	CA	CT	FL	GA	IL	IN	IA	KY	LA	ME	MD	MI	MN	NE	NH	NC	OH	OK	SC	SD	TX	UT	VA	WA
Any sale or lease or offer to sell or lease any product, equipment, suppliers or services which will aid or be used by a purchaser to begin, maintain or operate a business; OR	X	X	X	X	X	X	X	X	X	X	X ¹	X	X	X	X ²		X	X	X	X	X	X ³	X	X	X
An agreement where purchaser obtains the right to offer, sell or distribute goods manufactured or supplied by seller through vending machines, racks, display cases or similar devices (the " Vending Machines "); or purchases an inventory of products for sale or distribution through the Vending Machines; or purchases or leases Vending Machines from the seller.															X										
AND Initial payment greater than		500 X ⁴		500 X	500 X	500 X	500 X ⁴	500 X	500 X	300 X	250 X	300 X	500 X	500 X	500 X		200 X	500 X ⁴	500 X	250 X	250 X	500 X	300 X	500 X	300 X
AND ANY OF THE FOLLOWING:																									

¹ Including plants used for cultivation and animals used for breeding.

² Also licenses.

³ And seller represents that profits will be earned in excess of the initial payment.

⁴ But less than \$50,000.

DEFINITION	AL	CA	CT	FL	GA	IL	IN	IA	KY	LA	ME	MD	MI	MN	NE	NH	NC	OH	OK	SC	SD	TX	UT	VA	WA
1. Seller to provide or assist buyer to obtain locations and/or outlets for operation of vending machines, racks, display cases, currency-operated amusement machines, or other similar devices on premises neither owned nor leased by either buyer or seller; OR			X	X	X	X		X	X	X	X	X	X	X	X		X	X	X	X	X	X	X	X	X
2. Seller will buy products that buyer makes, fabricates, grows, breeds, or modifies by using products, equipment, supplies or services sold or leased to buyer; OR		X	X	X	X	X	X	X	X	X	X	X	X	X	X		X	X	X	X	X	X	X	X	X
3. Seller will provide a sales or marketing program to enable the buyer to get from the business income that exceeds the price paid for the business; OR			X	X	X ⁵	X		X		X ⁶	X	X	X		X		X		X	X	X	X	X ⁶	X	X ³
4. Seller will refund all or part of the price paid for the business or repurchase the products, equipment, or supplies sold or leased by the seller, if the buyer is not satisfied with the business; OR			X	X		X		X			X	X	X		X		X ⁷		X	X	X		X	X	

⁵ If the fee for the marketing program is more than \$500.

⁶ If the fee for the marketing program is more than \$300.

⁷ If consideration is less than \$200.

DEFINITION	AL	CA	CT	FL	GA	IL	IN	IA	KY	LA	ME	MD	MI	MN	NE	NH	NC	OH	OK	SC	SD	TX	UT	VA	WA
5. Seller represents or guarantees that the buyer will get from the business income that will exceed the purchase price; OR		X	X	X		X	X	X	X	X	X	X	X	X	X		X	X	X	X	X	X ³	X	X	X
6. Seller represents that there is a market for the business opportunity; OR		X					X		X						X			X							
7. Seller will sell, lease or distribute products; OR							X																		
8. Seller will pay the difference between initial payment and earnings.							X																		

APPENDIX C
BUSINESS OPPORTUNITY EXCLUSIONS

EXCLUSIONS	AL	CA	CT	FL	GA	IL	IN	IA	KY	LA	ME	MD	MI	MN	NE	NH	NC	OH	OK	SC	SD	TX	UT	VA	WA
Federally registered trademark or service mark			X ¹			X		X ²			X	X ²	X				X		X ²		X ²				
Registered trademark or service mark				X ³	X					X					X ^{3,4} ₅					X			X ⁶		X ⁷
Trademark or service mark		X ⁸																X ⁹						X ⁹	
Owner's sale of entire ongoing business and/or the sale of substantially all of the assets of an ongoing business		X	X	X	X	X	X	X	X	X	X	X		X ¹⁰	X		X	X	X	X	X	X	X	X	X
Sale, lease or transfer of only one business opportunity within a 12-month period																		X							X
Sale or lease to existing business which also sells or lease other products or services which are not produced by seller's products or services and account		X ¹¹													X			X				X			
Not for profit sale or sales demonstration equipment, materials or samples, for a \$500 or less purchase price per person			X	X		X	X	X	X	X	X	X ¹²		X	X		X ¹³		X	X	X	X	X ¹⁴	X ¹⁵	X ¹⁶
Payment is made for product inventory at a bona fide wholesale price						X		X							X				X	X	X				
Class exempted by Commissioner or Director or Administrator or Secretary of State						X		X				X		X	X	X	X		X		X				
A judicial offer or sale or one by an executor, administrator, sheriff, receiver, trustee in bankruptcy, guardian or conservator						X		X						X					X		X				
Security		X				X			X					X	X			X						X	X

EXCLUSIONS	AL	CA	CT	FL	GA	IL	IN	IA	KY	LA	ME	MD	MI	MN	NE	NH	NC	OH	OK	SC	SD	TX	UT	VA	WA
Franchise that is registered or exempt, or that complies with the FTC Rule		X		X		X	X	X	X			X	X	X	X			X	X		X	X	X	X	X
Newspaper Distribution System		X																						X	X
Fractional, Package or Product Franchise														X									X		
A radio station, television station, publisher, printer, or distributor of a newspaper, magazine, billboard, or other advertising medium which accepts advertising in good faith																		X							X
An agreement to sell products within or appurtenant to, a retail business as a department or division of such business																		X	X			X		X	
Minimum net worth of seller or 80% parent of seller who guarantees its performance (in millions)					15 ¹⁷	1	5 ¹⁹										5 ¹⁸	5 ¹⁹ ₂₀	1	10	1	25			
Responsible Sellers Exemption: Seller has not for previous 2 year and does not intend to derive net income from such sales in current year; primary activity of seller is different than such sales; the sale results in an improvement to realty of the purchaser which enables purchase to receive goods from seller																	X								
Sale of business opportunity where products provided are similar to purchaser's ongoing business						X		X										X	X						
Cash payment of at least \$25,000 if not in excess of 20% of the purchaser's net worth						X													X		X				
Purchaser's net worth at least \$250,000						X													X		X				

EXCLUSIONS	AL	CA	CT	FL	GA	IL	IN	IA	KY	LA	ME	MD	MI	MN	NE	NH	NC	OH	OK	SC	SD	TX	UT	VA	WA
Any transaction governed by Real Estate law in which either party is licensed by such law		X													X										
Sale, lease or offer to a purchaser who has previously bought products or services under the same trade or service mark or produced by the seller and who has received on sale of such products an amount equal to the initial payment		X													X			X ²¹							
Renewal or extension of existing business opportunity plan		X						X							X			X							
Sale of any training course for a fee of less than \$500				X																					
Sale or lease of laundry and dry cleaning equipment				X																					
Any relationship created solely by or involving an employer/employee; business partners; membership in or transactions between members and a bonafide cooperative association					X													X							
Any agribusiness					X																				
Any insurance agency					X																				
If purchaser is a bank, savings & loan, trust company, insurance company, credit union, investment company, pension & profit sharing trust or other financial institution or buyer						X		X						X					X		X				
A newspaper that is published outside the state or has 2/3 of its circulation outside the state or a radio or television program that originates outside the state and is received in the state												X													

EXCLUSIONS	AL	CA	CT	FL	GA	IL	IN	IA	KY	LA	ME	MD	MI	MN	NE	NH	NC	OH	OK	SC	SD	TX	UT	VA	WA	
Registered and approved pursuant to the laws of the US or any other state																X										
Transactions regulated by state motor vehicle commission, department of licensing and regulation, insurance or real estate or federal Petroleum Marketing Practices Act												X										X				

- 1 For trademarks initially registered after 10/1/96, a copy of the trademark certificate must be filed to claim the exemption.
- 2 If seller has a net worth of \$1 million or its 80% parent with a net worth of \$1 million guarantees its performance.
- 3 Either federal or state registration.
- 4 License is to general merchandise retailer who has been doing business continuously for 5 years.
- 5 Also items protected by copyright and patent laws.
- 6 Either Federal or registered with Utah or the state of incorporation.
- 7 For which no consideration is received.
- 8 Seller must also meet the following criteria: (i) doing business in state for 5 continuous years; (ii) sells diverse kinds of products or services; (iii) sells same products and services to general public; and (iv) during previous 12 months its direct sales of such products or services to the public were at least 50% of its yearly sales of such products or services under the mark.
- 9 Seller doing business continuously for 5 years and also sells same products directly to the public.
- 10 Limited to sale of franchise by franchisee or entire area franchised by subfranchisor.
- 11 And for which such sales are in excess of 25% of purchaser's business.

-
- 12 Less than \$550.
- 13 For a purchase price of \$200 or less.
- 14 For a purchase price of \$300 or less.
- 15 At cost for use in making sales, but not for resale.
- 16 Purchase of goods at a bona fide wholesale price for any consideration.
- 17 And be publicly traded, have securities registered with SEC, not failed to pay a dividend or defaulted on a loan, have an annual trading volume of not less than 3,000,000 shares and an aggregated value of voting stock \$100 million.
- 18 Does not include guarantor's net worth and the primary commercial activity of the seller is motor carrier transportation and the seller is subject to ICC (or other federal agency) jurisdiction.
- 19 To guarantee performance, the seller must have a net worth of \$2 million (\$1 million in Indiana) and the 80% owner (guarantor) must have a net worth of \$5 million.
- 20 Plus had 25 purchasers conducting business at all times during the preceding 5 year period or conducted such business opportunity business continuously for not less than 5 years.
- 21 Or, previously engaged in such business for at least 1 year and earned at least \$25,000 from such business in any 1 year.