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**THE HIDDEN FRANCHISE**  
**What the Practitioner Should Know**  
**When the Client Does Not Know if its Business is a Franchise**

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**by**

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## THE HIDDEN FRANCHISE

### ***Is your client's business a franchise?***

Frequently, the answer is clear. It doesn't take a lawyer or one with special expertise to know when certain types of businesses are franchises and others are not. However, the boundaries of the definition of a franchise can be surprisingly broad. There is a large grey area. How do you begin to deal with the question? A good starting point is who is asking the question and why.

### ***Who is asking the question and why?***

The question of whether a business is a franchise can arise in any number of contexts. In some cases, you will be able to plan whether the arrangement is a franchise. Is the client in the planning stages of a business venture that may be a franchise? Does the client plan to start a franchise business, but only after some testing in a nonfranchise mode? Does the client want to avoid franchising altogether? In other cases, you may have to deal with the facts as the client presents them to you. Is your client facing an allegation from a distributor or licensee that the business is a franchise? Is a regulator investigating possible wrongdoing under a franchise law? Does the client want to terminate an agreement with a company that may be a franchisee? In these situations, you will want to know the strength of your case and ways to chart a course toward compliance or resolution of a dispute.

### ***What franchise laws are we talking about?***

The question of whether the business is a franchise commonly arises when a client is concerned about registration and disclosure requirements. The franchise registration and disclosure laws are roughly modeled after the securities laws. These laws require franchisors to give an extensive disclosure document to prospective franchisees and sometimes require that the offer be registered. These laws exist at both the federal and state levels. Other types of franchise laws also may apply. The most significant such laws are the state franchise relationship laws, which limit a franchisor's ability to terminate or refuse to renew a franchise agreement without good cause. The franchise relationship laws grow out of a tradition of distributor protection laws. A business may constitute a franchise for purposes of some laws and not for others.

### ***What does being a franchise and complying with the franchise disclosure laws entail?***

Being a franchise and complying with the franchise registration and disclosure laws can be costly. Under the registration and disclosure laws, franchise compliance requires preparation of a franchise agreement, audited financial statements, a detailed offering circular, and registration in several states. As an ongoing matter, a franchisor must integrate the franchise disclosure requirements into its method of selling franchises. Compliance requires timely delivery of an offering circular to all prospective franchisees, timely amendments of

offering circulars and renewals of registrations, and annual audited financials. On the other hand, complying with the franchise disclosure laws provides a safe harbor. The client need not monitor its business carefully in order to avoid becoming a franchise unwittingly. Compliance allows the client to exercise significant control. After a full analysis of the question, the client may decide that it is worthwhile not to avoid the franchise laws, but to take the approach of full disclosure.

### ***The FTC Rule***

The Federal Trade Commission's trade regulation rule on franchising (the "FTC Rule") applies to franchises throughout the United States. It requires the franchisor to prepare a franchise offering circular and deliver it to each prospective franchisee before the prospective franchisee signs an agreement or pays any fee to the franchisor. It also limits the franchisor's ability to make representations to prospective franchisees beyond the content of the offering circular. While the FTC Rule applies throughout the U.S., it does not require registration.

### ***State Franchise Disclosure Laws***

Fewer than one-third of the states have laws similar to the FTC Rule, requiring franchisors to make extensive disclosures to prospective franchisees before franchises are offered or sold. These states include California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, Virginia and Washington. In addition, Michigan and Wisconsin require simple filings. Many of these states also require registration of the offer, which in some cases entails a lengthy review process and revisions to the franchise offering circular. The FTC Rule does not preempt the state franchise laws.

### ***What are the potential consequences of noncompliance?***

Being a franchise and not complying with the franchise registration and disclosure laws can be costly. Violation of the FTC Rule does not give rise to a private right of action. Nevertheless, the FTC can seek permanent injunctions, rescission and restitution in court without initiating administrative proceedings. In addition, the FTC may bring an action in federal court. A federal district court may exercise equitable powers and order any relief necessary to make permanent relief possible. Such relief may include an assets freeze, consumer redress and criminal liability.<sup>1</sup> Failure to comply with the state franchise laws can result in both administrative proceedings and private actions by franchisees for rescission, damages, injunctive or declaratory relief, attorneys' fees, and costs. Where the violation is willful, the states allow for punitive damages and criminal liability. Nonlegal risks include the possibility of bad publicity and the consequent loss of business.

### ***State Franchise Relationship Laws***

The question of whether a business is a franchise can arise in the context of the termination, nonrenewal or transfer. A distributorship, license or sales representative arrangement may be viewed as a franchise under the franchise relationship laws of a number of states. The

franchise relationship laws, as distinguished from the registration and disclosure laws, impose substantive requirements that may limit the client's ability to terminate or refuse to renew or approve a transfer without good cause.

### ***Business Opportunity Laws***

In addition, you may need to consider the business opportunity laws of a number of states. Approximately half of the states have "business opportunity" laws. At the federal level, the FTC Rule applies not only to franchises, but also to business opportunities, such as sellers of rack displays and vending machines. Like the franchise laws, the business opportunity laws contain disclosure requirements and sometimes require a filing.

### ***Little FTC Acts***

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

All fifty states and the District of Columbia have enacted consumer protection statutes, most of which also prohibit "unfair or deceptive practices" or the like. A number of these laws are sometimes referred to as "little FTC Acts", because violations of the FTC Act will also constitute violations of these laws. In franchising, a violation of the FTC Rule can constitute a violation of one of the "little FTC Acts" in a state that otherwise does not regulate franchising as such. Violation of a "little FTC Act" may result in state enforcement and may give rise to a private right of action under state law, even though there may be no private right of action under the FTC Act.

### ***Does it matter what the parties call the relationship?***

It is generally accepted that a relationship may constitute a franchise regardless of the label the parties use. The FTC indicated as follows in its Statement of Basis and Purpose:

... a relationship may be a franchise for the purposes of the rule regardless of the label that the parties attach to it. If the arrangement has the characteristics of a "franchise" ... it is within the scope of the rule whether or not it is referred to as a "franchise," a "distributorship," a "purchase agreement," an "independent contractor agreement," or some other term.<sup>2</sup>

Similarly, at least one court has held that the label the parties give to the relationship does not preclude the finding of a "franchise" under New York law.<sup>3</sup>

### ***Does the contractual choice of law matter?***

State franchise disclosure laws generally apply when an offer or sale of a franchise is made in the state or when the franchise is to be operated in the state. Franchise relationship laws generally apply to franchises located within the state. In most cases, the franchise laws will apply in accordance with their terms, regardless of the parties' contractual choice of law.

In New York, the application of the franchise law can be very broad. The New York Franchise Sales Act specifically states that an offer to sell is made in the state "when the offer either originated from this state or is directed by the offeror to this state and received at the place to which it is directed." The extraterritorial application of the Act was upheld in at least one case,<sup>4</sup> where the court applied the New York Franchise Sales Act when the offer merely originated in New York, even though the offerees and the franchised businesses were outside the state. On the other hand, in recent enforcement actions the New York State Attorney General's office did not seek to apply the New York franchise law to franchises of a New York franchisor located outside of the state.<sup>5</sup>

In some cases, courts have applied the franchise law of the franchisor's state beyond the state's boundaries with little basis under the state franchise law, even when the contract provides for the application of the laws of a different state.<sup>6</sup>

At the opposite end of the spectrum, a court may be inclined to apply the contractual choice of law, even when the result is surprising. A franchisor based in New Jersey, for example, must think twice about choosing New Jersey law to govern the agreement when the franchisee is located outside the state.<sup>7</sup>

### ***Definition of a Franchise under the FTC Rule***

What then is a franchise? The definition of a franchise under the FTC Rule includes three elements – a trademark, a fee and significant control or assistance.<sup>8</sup>

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

The Commission does not intend to cover package or product franchises in which no mark is involved. If a mark is not necessary to a particular distribution arrangement, the supplier may avoid coverage under the rule by expressly prohibiting the use of its mark by the distributor.<sup>9</sup>

In other words, if a product or service sold by a distributor is identified by a mark, the only way to be sure to avoid meeting the trademark element is by including in the distribution agreement an express prohibition of the use of the mark by the distributor. In fact, the mere

possibility that a distributor can use the manufacturer's trademark suffices for purposes of the trademark element of the definition of a franchise under the FTC Rule.<sup>10</sup>

The second element in the definition of a franchise under the FTC Rule is significant control or assistance. This element is satisfied if the franchisor (a) exerts or has authority to exert a significant degree of control over the franchisee's method of operation, or (b) gives significant assistance to the franchisee in the franchisee's method of operation. The FTC explained this requirement as follows in its Interpretive Guides:

The term "significant" relates to the degree to which the franchisee is dependent upon the franchisor's superior business expertise – an expertise made available to the franchisee by virtue of its association with the franchisor. The franchisee, in order to reduce its business risks or enhance its chances for business success, relies upon the availability of such expertise to avoid business mistakes that it otherwise might make. The franchisor conveys its expertise either by exercising controls over the franchisee's method of operation of the business or by furnishing assistance to the franchisee in areas relating to the franchisee's method of operation. If the controls over or assistance to the franchisee's method of operation of the business are "significant", then this second element of the rule's definition is met.

Among the significant types of controls over the franchisee's method of operation are those involving a) site approval for unestablished businesses, b) site design or appearance requirements, c) hours of operation, d) production techniques, e) accounting practices, f) personnel policies and practices, g) promotional campaigns requiring franchisee participation or financial contribution, h) restrictions on customers, and i) location or sales area restrictions.

Among the significant types of promises of assistance to the franchisee's method of operation are a) formal sales, repair or business training programs, b) establishing accounting systems, c) furnishing management, marketing or personnel advice, d) selecting site locations, and e) furnishing a detailed operating manual.<sup>11</sup>

The FTC went on to say that the presence of "any" of the elements listed above "would suggest the existence of "significant control or assistance."

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

The Commission's objective in interpreting the term "required payment" is to capture all sources of revenue which the franchisee must pay to the franchisor or its affiliate for the right to associate with the franchisor and market its goods

or services. Often, required payments are not limited to a simple franchise fee, but entails other payments which the franchisee is required to pay to the franchisor or an affiliate, either by contract or by practical necessity. Among the forms of required payments include initial franchise fees as well as those for rent, advertising assistance, required equipment and supplies – including those from third parties where the franchisor or its affiliate receives payment as a result of such purchases – training, security deposits, escrow deposits, non-refundable bookkeeping charges, promotional literature, payments for services of persons to be established in business, equipment rental, and continuing royalties on sales.<sup>12</sup>

### ***Definition of a Franchise under the State Registration and Disclosure Laws***

As in the FTC Rule, the definitions of a “franchise” under most state franchise laws also contain three elements.<sup>13</sup> The trademark and fee elements of the state laws are parallel to the FTC Rule. However, instead of “control or assistance,” the state laws generally refer to a “marketing plan or system prescribed in substantial part by a franchisor ....” Under most of these laws, all three elements must be present in order for the arrangement to constitute a franchise.

Of all the state franchise disclosure laws, the one with the broadest definition of a franchise is New York. The definition of a franchise in New York includes a required fee and either a trademark or a marketing plan element, not both.<sup>14</sup> In New York, elimination of either the marketing plan element or the trademark element will not suffice to avoid application of the New York franchise sales law.

### ***Definition of a Franchise under the State Franchise Relationship Laws***

Several of the state franchise relationship laws also define a franchise as containing a trademark element, a fee element and a marketing plan element.<sup>15</sup>

Some of the franchise relationship laws do not include a marketing plan element in their definition of a franchise, but rather require that there be a “community of interest” between the franchisor and franchisee. States with this type of definition of a franchise include New Jersey and Wisconsin, among others.<sup>16</sup> The definition of a “community of interest” can be extremely broad.

In fact, a number of the franchise relationship laws cover not just franchises, but many dealerships and distribution arrangements as well. Manufacturers and suppliers who enter into agreements with distributors, wholesalers or retailers in Arkansas, Connecticut, Missouri, New Jersey or Wisconsin must be particularly careful. The relationship laws of these states define the term “franchise” without a fee element.

### ***Definition of a “Business Opportunity”***

While the business opportunity laws vary from state to state, these laws generally define a business opportunity broadly.<sup>17</sup> The representations made in conjunction with the marketing and sale of the business opportunity are central to the question of the coverage under these laws.<sup>18</sup> Aside from rack display and vending machine sales, these laws often come into play when the seller represents that it will purchase the products made using the goods or services sold to the purchaser, or the seller guarantees in writing that the purchaser will derive income from the opportunity.

### ***Exemptions and Exclusions***

The FTC Rule and the various state franchise registration and disclosure laws contain a number of exemptions and exclusions. Some exemptions and exclusions are common to a number of these laws. Others may be unique to the FTC Rule or the laws of only one or a few states. In some cases, an arrangement may be exempt from filing requirements but not disclosure requirements. In other cases, an exemption requires some type of filing or approval. Here are some of the exemptions and exclusions available under these laws:

#### *Nominal Fee*

The FTC Rule excludes from the definition of a “franchise fee” payments of less than \$500 required to be made before and within six months after the franchisee opens for business. Several of the states also have exclusions for small payments on an annual basis.

#### *Bona Fide Wholesale Price*

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

A number of states have specific exclusions for specific types of purchases in addition to inventory. New York, for example, specifically excludes the “purchase of sales demonstration equipment and materials furnished at cost for use in making sales and not for resale” and the “purchase or lease, at fair market value, of real property ... necessary to enter into the business ... under the franchise agreement.”<sup>19</sup>

#### *Fractional Franchise*

The FTC Rule exempts “fractional franchises”. To the extent that the business offered is a mere adjunct to a customer’s existing business, the offered business may constitute a “fractional franchise” under the FTC Rule. The exemption for “fractional franchises” is available under the FTC Rule only if the franchisee or any of its directors or executive officers has had more than two years of prior management experience in the business represented

by the franchise and the parties anticipate at the time of entering into the agreement that sales under the agreement will represent no more than 20% of the dollar volume of the franchisee's projected gross sales within the reasonably foreseeable future.<sup>20</sup>

A few states also have fractional franchise exemptions. In those states that do not have fractional franchise exemptions by statute, the courts have generally found fractional franchises not to be covered by the state franchise laws. In other words, a business that would be a “fractional franchise” under the FTC Rule is unlikely to be a franchise for state law purposes.

#### *Qualified Purchaser*

The FTC Rule contains no exemption for offers to sophisticated purchasers.<sup>21</sup>

The franchise laws of several states exclude sales to existing franchisees and to owners, officers and directors of the franchisor. Only Rhode Island and Washington exclude sales to purchasers with a high net worth (at least \$1 million) or a high income (at least \$200,000 for the last two years).

#### *Large Franchisor*

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

#### *Sale by a Franchisee*

The offer or sale of a franchise by a franchisee for its own account is generally excluded from the coverage of the franchise laws. Practically speaking, most franchisors become involved in the process of approving the transferee and ask the transferee to sign a new franchise agreement. In such cases, franchisors typically make full disclosure to purchasers. The selling franchisees are not required to comply with the franchise laws.

#### *Isolated Sales*

The FTC Rule excludes the grant of the right to use a trademark “where the license is the only one of its general nature and type to be granted by the licensor with respect to the trademark.”<sup>22</sup>

A few states also exempt certain isolated sales or limited offers. New York, for example, exempts certain offers directed to not more than two persons as long as the offer did not confer subfranchising rights, no commission is paid and the franchisor is either domiciled in the state or has filed a consent to service of process.

### *Other Exemptions and Exclusions*

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

### *Out-of-State Sales*

California and a few other states specifically exempt sales when the franchised business is to be operated outside of the state.

### *Statute of Limitations*

Many of the state franchise laws have specific statutes of limitations. In New York, for example, rescission is available if the violation is willful. However, the remedy of rescission is subject to a three-year statute of limitations.<sup>23</sup>

### *Multiline Distribution Under the State Franchise Relationship Laws*

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

### *Business Opportunity Law Exemptions*

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

Each state has its own additional exclusions and exemptions. The Connecticut business opportunity law, for example, exempts offers to purchasers with a net worth of at least \$1 million.

## *New York Cases*

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

In June, 2000, the state Attorney General's office announced a settlement with the owner of Tiger Schulmann's Karate Centers, the state's largest chain of karate schools.<sup>24</sup> The Attorney General's position was that the centers were franchises because they paid franchise fees, taught the same style of karate, used the same logos and pooled their monies for advertising. The owner agreed to pay \$195,000 in penalties and costs and to comply with the New York state franchise law. He agreed to register the chain as a franchise and provide franchisees a copy of the company's franchise offering circular. In addition, he agreed to give franchisees the right to rescind their agreements.

In New York, black car and limousine services have been held to be franchises. The initial case that so held involved a company called Aristacar Corp.<sup>25</sup> Aristacar owned and operated a non-medallioned radio dispatch car service licensed by the City's Taxi and Limousine Commission. The company was also licensed by the FCC to operate over a two-way radio frequency. Aristacar sold license rights to drivers for a fee and service charge. Under these the agreements with the drivers, the company served as a base from which the two-way radio network operated, furnished radio equipment and procured customers which were allotted to the drivers through Aristacar's bidding system. The drivers operated their own automobiles, although the brand, style and age of the permitted cars were defined in the agreement. Drivers were required to affix the Aristacar logo to their vehicles to enable the customers to identify the vehicles when they arrived at the pick-up locations.

One court held that the New York franchise law applied to exclusive distributorships for beepers that transmitted sports information. In that case, distributors paid an initial fee and ongoing service fees. The defendant's trademark, "Beeper Plus", was disseminated by radio on the beeper screens.<sup>26</sup>

As broad as the New York franchise law is, it does have limits. In one New York case, the court held that a distribution arrangement was not a franchise when the plaintiff bought the alleged franchise from the distributor and not the supplier.<sup>27</sup> The seller sold the right to purchase bakery goods at wholesale directly from a bakery, and to distribute them in a specified area. The bakery then went out of business and the buyer sought to rescind the purchase agreement based on an alleged violation of the New York franchise law. The court held this was not a franchise because the buyer paid no franchise fee to the bakery and the bakery did not regulate or control the buyer's sales activities.

In addition, although violation of the New York franchise law may give rise to a right of rescission, it does not extinguish all contract rights. In one case, although a radio-dispatch car service operator failed to comply with the New York franchise law, the court declined to dismiss the company's action against the former franchisees and a competitor for breach of contract and tortious interference with contractual relations.<sup>28</sup>

## *Other Examples*

The franchise relationship laws are generally broader in scope than the franchise disclosure laws. The relationship laws cover many dealership and distribution arrangements. For example, courts have held dealership and distribution arrangements to be franchises under the relationship laws of Indiana,<sup>29</sup> Missouri<sup>30</sup> and New Jersey.<sup>31</sup>

While less common, courts have also found some distributorship arrangements to constitute franchises under the registration and disclosure laws of some states, including Indiana,<sup>32</sup> Minnesota<sup>33</sup>, North Dakota<sup>34</sup> and Washington.<sup>35</sup> Most distributorship arrangements are not franchises for purposes of the franchise registration and disclosure laws.

A license to manufacture and sell a product was held in one case to be within the scope of the Connecticut Franchise Act, a franchise relationship law, because the licensor imposed wide-ranging requirements.<sup>36</sup>

A sales representative agreement is generally regarded as not being a franchise. The FTC's Interpretive Guides indicate that agents compensated by commission are generally not franchisees: "Agency relationships in which independent agents, compensated by commission, sell goods or services (*e.g.* insurance salespersons) are excluded, since there is no 'required payment.'" <sup>37</sup> However, a California appellate court held that an agreement whereby the plaintiff solicited orders on behalf of the defendant was in fact a "franchise" within the meaning of the California Franchise Investment Law (a registration and disclosure law).<sup>38</sup> The court so held even though all orders were subject to acceptance by the manufacturer, who set prices and terms of sale, billed customers, and received customer payments. The court noted that, in addition to soliciting orders, the plaintiffs demonstrated products, solved customer problems, installed systems, maintained contact with existing customers, generated new business, and provided ongoing service to customers. This description is not terribly different from the role that most sales representatives play.

Not all arrangements that look like franchises are franchises.

In one case, a former distributor of Whirlpool appliance parts claimed that Whirlpool Corporation had violated the Michigan Franchise Investment Law by failing to approve the proposed sale of the distributor's business. The court held that the plaintiff was not a franchise under the Michigan Franchise Investment Law because the distribution agreement did not prescribe a marketing plan or system.<sup>39</sup>

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

The FTC has exempted most gas stations from the FTC Rule on the basis that they are already covered by the federal Petroleum Marketing Practices Act. Gas station leases are also

generally deemed not to be franchises under state law,<sup>40</sup> but can be franchises if the lessor imposes significant controls.<sup>41</sup> Significant controls may include control over hours and days of operation, advertising, financial support, auditing of books, inspection of premises, control of lighting, employee uniforms, prices, hiring, sales quotas and management training.

One court held that an Internet company that assisted auto dealerships to sell their cars was not a franchise under the Michigan Franchise Investment Law. Auto-By-Tel provided auto dealerships with a means of selling their vehicles to a wider range of potential buyers over the Internet. The court regarded the dealership as ABT's customer rather than its franchisee.<sup>42</sup> Auto-By-Tel required subscribing dealerships to train one employee as an "Auto-By-Tel representative," dictated the length of time that dealerships were to leave an offered price on the table, and closely scripted the interactions between dealerships and the referred customers. The court held that these factors were not sufficient to constitute a marketing plan. The court noted that Auto-By-Tel exercised no control whatsoever over the day-to-day business decisions of subscribing dealerships. The dealerships set their own hours of operation, hired and trained employees subject to their own policies, and set their own sales goals. In addition, Auto-By-Tel conducted no audits of the books of the dealerships because these dealerships functioned independently of Auto-By-Tel.

A collection agency "franchisor" that provided a structure for the sharing of the amounts collected among the customer, the alleged "franchisee" and the "franchisor" was held not to be a franchise under the Michigan Franchise Investment Law. The court held there was no marketing plan because the alleged franchisor did not assist the "franchisee" in the affirmative act of selling its services.<sup>43</sup>

### ***Avoiding the Franchise Laws***

One way to be sure that a retail operation with multiple outlets is not a franchise is to open nothing other than company-owned stores. This approach avoids the cost of franchise compliance and the risks of noncompliance. A chain with existing franchisees can buy out the individual stores, making them company-owned.

As soon as the ownership of the outlets is other than the supplier or brand owner, the issue of whether the arrangement is a franchise arises. If the arrangement or planned arrangement is a franchise, here are some ways that the client might change the system in order to avoid being a franchise:

One way to avoid the franchise laws is to enter into a strategic alliance with a company that already has a chain of outlets. You client would simply supply the product or service, and the other company would find the ultimate customers. This can provide instant expansion at a low cost and without franchise compliance issues.

Another possible approach is to refrain from charging any fees until after the franchisee has been in business for at least six months, or keep the fees under \$500 during this initial period. It does not matter how high the fees or royalties are after the first six months. This will bring the arrangement out from under the requirements of the FTC Rule, but may not work in all states.

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

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

Similarly, exclusion of the marketing plan element may not suffice to avoid application of the New York franchise law. However, it will work in all other states. The grantor must be careful not to exercise significant control and to give no assistance other than advertising and promotional assistance.

Another approach in states that define a franchise as including a marketing plan is to make the marketing plan entirely optional, leaving purchasers free to run their businesses as they like. The marketing plan as a component of the definition of a franchise must generally be "prescribed" in substantial part by the franchisor.

In many cases, a company can avoid the franchise laws by approaching dealers with established businesses and offering the product as an addition to the dealers' preexisting businesses. This will frequently fall within the "fractional franchise" exemption of the FTC Rule and similar exemptions or case-law exclusions in most states.

Some companies think that they are avoiding the franchise laws by opening outlets that are commonly owned by the supplier (or licensor) and the operator of the outlet. You need to look very closely at this type of arrangement. The fact that the grantor is a part owner does not remove the arrangement from coverage by the franchise laws. If the elements of a franchise are otherwise present, the arrangement will be a franchise.

What about "conversion" franchises? In other words, if a franchisor sells a real estate brokerage franchise to a company that is already a real estate brokerage firm, does that sale constitute the sale of a franchise? In that case, the purchaser is affiliating itself with the franchisor, and the purchase does not have the appearance of the grant of a right to do business. Companies that are already selling franchises would take the safe route of complying with the franchise disclosure requirements in these cases. However, there is some authority to indicate that such a sale might be deemed to be a fractional franchise.<sup>44</sup>

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

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

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

If the proposed arrangement might arguably be a franchise, consider seeking advisory opinions or exemptions from the FTC and the relevant states. This can provide assurance from a legal point of view. However, it can also cause delays and may yield an undesired result.

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

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

If your client is already a franchise but has not complied with the franchise laws, you may want to consider either buying out the franchisees or offering them rescission. One approach would be to convert the system to a franchise and offer a special deal to existing franchisees while at the same time offering them rescission.

### ***Where can I find more information?***

The best source of information to research the franchise laws is the CCH Business Franchise Guide. It contains all of the federal state franchise and business opportunity laws and regulations, and all cases decided under these laws and others that affect franchising.

The American Bar Association's Forum on Franchising is another excellent source of information on franchise law.

The California Commissioner of Corporations has issued a pamphlet that explains in detail the scope of the California Franchise Investment Law. Release No. 3-F, *When Does an Agreement Constitute a Franchise?*, Bus. Franchise Guide (CCH) ¶ 5050.45.

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## ENDNOTES

<sup>1</sup> Consumer redress in one case amounted to more than \$9,000,000. *FTC v. Jordan Ashley*, Bus. Franchise Guide (CCH) ¶10,425 (1994). In another case, an individual charged with conspiracy to violate the FTC Rule was sentenced to three years in prison and ordered to pay \$80,500 in restitution. *U.S. v. Jaspon*, Bus. Franchise Guide (CCH) ¶9773 (1991).

<sup>2</sup> Bus. Franchise Guide (CCH) ¶6350, footnote 25.

<sup>3</sup> *Aristacar Corp. v. Attorney General of the State of New York*, Bus. Franchise Guide (CCH) ¶9369 (1989).

<sup>4</sup> *Mon-Shore Management v. Family Media*, 584 F. Supp. 186 (S.D.N.Y. 1984).

<sup>5</sup> See “Settlement with New York State’s Largest Karate School Chain Ends Deceptive Practices,” [www.oag.state.ny.us/press/2000/nov/nov27a\\_00.html](http://www.oag.state.ny.us/press/2000/nov/nov27a_00.html) (Press Release, Nov. 27, 2000).

<sup>6</sup> See *Instructional Systems, Inc. v. Computer Curriculum Corp.*, No. 93-5414 (3d Cir. Sept. 16, 1994) (slip opinion), *cert. denied*, 63 U.S.L.W. 3477 (February 21, 1995). In that case, the New Jersey Supreme Court held that the New Jersey Franchise Practices Act, a relationship law, applied to the nonrenewal of a franchise agreement for parts of the franchisee's territory outside of the state of New Jersey, even though the contract called for the application of California law and all of the franchisee's territory within the state of New Jersey was included in the renewal agreement. Similarly, in *Wright-Moore Corp. v. Ricoh Corp.*, 908 F.2d 128, Bus. Franchise Guide (CCH) ¶9665 (7th Cir. 1990), the court held that the Indiana Franchise Practices Act applied to the nonrenewal of an agreement with a national distributor based in Indiana although the contract called for the application of New York law.

<sup>7</sup> In *Dep't of Motor Vehicles v. Mercedes-Benz*, 408 So.2d 627 (Fla. 1981), modified 455 So.2d 404 (Fla. 1984), *pet. for rev. den.* 462 So.2d 1107 (Fla. 1985). a Florida court held that the NJFPA applied where the agreement called for the application of New Jersey law, even though the franchisee and the franchised business were located in Florida. The court ruled that the contractual choice of New Jersey law evidenced an intent that the NJFPA should apply.

<sup>8</sup> The Federal Trade Commission trade regulation rule on franchising (the "FTC Rule") contains the following definition of a “franchise”:

“The term ‘franchise’ means any continuing commercial relationship created by any arrangement or arrangements whereby:

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(1)(i)(A) a person (hereinafter ‘franchisee’) offers, sells, or distributes to any person other than a ‘franchisor’ (as hereinafter defined), goods, commodities, or services which are:

(1) Identified by a trademark, service mark, trade name, advertising or other commercial symbol designating another person (hereinafter ‘franchisor’); or

(2) Indirectly or directly required or advised to meet the quality standards prescribed by another person (hereinafter ‘franchisor’) where the franchisee operates under a name using the trademark, service mark, trade name, advertising or other commercial symbol designating the franchisor; and

(B) (1) The franchisor exerts or has authority to exert a significant degree of control over the franchisee’s method of operation, including but not limited to, the franchisee’s business organization, promotional activities, management, marketing plan or business affairs; or

(2) The franchisor gives significant assistance to the franchisee in the latter’s method of operation, including, but not limited to, the franchisee’s business organization, management, marketing plan, promotional activities, or business affairs; *Provided, however,* That assistance in the franchisee’s promotional activities shall not, in the absence of assistance in other areas of the franchisee’s method of operation, constitute significant assistance; or

(ii) [*this provision deals with business opportunity ventures*]... and

(2) The franchisee is required as a condition of obtaining or commencing the franchise operation to make a payment or a commitment to pay to the franchisor, or to a person affiliated with the franchisor.”

<sup>9</sup> Bus. Franchise Guide (CCH) ¶ 6205, 44 *Fed. Reg.* 49966 (Aug. 24, 1979).

<sup>10</sup> *Informal FTC Staff Advisory Opinion to U.S. Marble, Inc.*, Bus. Franchise Guide (CCH) ¶ 6424 (1980).

<sup>11</sup> Bus. Franchise Guide (CCH) ¶ 6206, 44 *Fed. Reg.* 49966 (Aug. 24, 1979).

<sup>12</sup> Bus. Franchise Guide (CCH) ¶ 6207, 44 *Fed. Reg.* 49966 (Aug. 24, 1979).

<sup>13</sup> A typical example of a franchise disclosure law is the California Franchise Investment Law. Section 31005(a) of that law defines a “franchise” as follows:

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“‘Franchise’ means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

(1) A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and

(2) The operation of the franchisee’s business pursuant to such plan or system is substantially associated with the franchisor’s trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and

(3) The franchisee is required to pay, directly or indirectly, a franchise fee.”

<sup>14</sup> Section 681 of the New York General Business Law contains the following definition:

“‘Franchise’ means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

(a) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor, and the franchisee is required to pay, directly or indirectly, a franchise fee, or

(b) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor’s trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate, and the franchisee is required to pay, directly or indirectly, a franchisee fee.”

<sup>15</sup> The Connecticut Franchise Act defines “franchise” in Conn. Gen. Stat. Ann. §42-133e as follows:

“Franchise” means an oral or written agreement or arrangement in which (1) a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor . . . ; and (2) the operation of the franchisee’s business pursuant to such plan or system is substantially associated with the franchisor’s trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate . . . .”

<sup>16</sup> Under the New Jersey Franchise Practices Act (N.J. REV. STAT. §56:10-3):

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

Under the Wisconsin Fair Dealership Act (WIS. STAT. §135.02(3)):

“Dealership” means a contract or agreement, either expressed or implied, whether oral or written, between 2 or more persons, by which a person is granted the right to sell or distribute goods or services, or use a trade name, trademark, service mark, logotype, advertising or other commercial symbol, in which there is a community of interest in the business of offering, selling or distributing goods or services at wholesale, retail, by lease, agreement or otherwise.”

<sup>17</sup> The California law is one example. Under Section 1812.201 of the California law, a business opportunity is called a “seller assisted marketing plan,” which is defined as follows:

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

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

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

(3) Represented that the seller will buy back or is likely to buy back any product made, produced, fabricated, grown or bred by the purchaser using, in whole or in part, the product, supplies, equipment or services which

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were initially sold or leased or offered for sale or lease to the purchaser by the seller assisted marketing plan seller.”

<sup>18</sup> For example, an educational seminar in which the sponsor sold products and services that would enable purchasers to operate as brokers or factors was found to be a business opportunity under Connecticut law, where the sponsor offered a no-risk guarantee under which a purchaser could receive a full refund if he fails to earn a profit within a stated period of time. *Connecticut Department of Banking, Securities and Business Investments Division* (1994) Bus. Franchise Guide ¶10,424.

<sup>19</sup> NY. Gen. Bus. Law §681.1(7).

<sup>20</sup> 16 CFR §436.2(h).

<sup>21</sup> The proposed revised FTC Rule contains exemptions for sales where the initial investment exceeds \$1.5 million and for corporations that have been in business for at least five years and have a net worth of at least \$5 million.

<sup>22</sup> 16 CFR §436.2(4)(iv).

<sup>23</sup> NY GBL § 691(4).

<sup>24</sup> See “Settlement with New York State’s Largest Karate School Chain Ends Deceptive Practices,” [www.oag.state.ny.us/press/2000/nov/nov27a\\_00.html](http://www.oag.state.ny.us/press/2000/nov/nov27a_00.html) (Press Release, Nov. 27, 2000).

<sup>25</sup> *Aristacar Corp. v. Attorney General of the State of New York*, Bus. Franchise Guide (CCH) ¶9369 (1989).

<sup>26</sup> *King Computer, Inc. v. Beeper Plus, Inc.*, Bus. Franchise Guide (CCH) ¶10,182 (1993).

<sup>27</sup> *Charles Kennedy v. Dominick Lomei*, Bus. Franchise Guide (CCH) ¶10,048 (1991)

<sup>28</sup> *TKO Fleet Enterprises, Inc. v. Elite Limousine Plus, Inc.*, Bus. Franchise Guide (CCH) ¶11,855 (2000). See also *Moseley’s & Co. v. The Maxim Group, Inc.*, Bus. Franchise Guide (CCH) ¶11,664 (1999) (holding that a contract was not void ab initio under the Illinois Franchise Disclosure Act when the franchisor had not complied with the requirements of the law).

<sup>29</sup> *Wright-Moore Corp. v. Ricoh Corp.*, 908 F.2d 128 (7th Cir. 1990), *aff’d*, 980 F.2d 432 (7<sup>th</sup> Cir. 1992) (holding that a photocopier distributor was protected from nonrenewal by the Indiana Deceptive Franchise Practices Act).

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<sup>30</sup> See *American Bus. Interiors, Inc. v. Haworth, Inc.*, 798 F.2d 1135 (8th Cir. 1986) (holding that an office furniture dealer was protected from termination by the Missouri Franchises Law).

<sup>31</sup> *Instructional Systems, Inc. v. Computer Curriculum Corp.* No. 93-5414 (3d Cir. Sept. 16, 1994) (slip opinion), *cert. denied*, 63 U.S.L.W. 3477 (February 21, 1995) (holding a distributor to be a franchise even though the distributor operated under its own name); *Carlos v. Philips Bus. Sys., Inc.*, 556 F. Supp. 769 (E.D.N.Y. 1983), *aff'd in part and rev'd in part*, 744 F.2d 287 (2d Cir. 1984) (holding that a distributor of dictation machines was protected from termination by the New Jersey Franchise Practices Act).

<sup>32</sup> *Master Abrasives Corp. v. Dean Williams*, 469 N.E. 2d 1196, Bus. Franchise Guide (CCH) ¶8248 (Ind App. 1984) (holding an equipment distributorship to be entitled to damages and attorneys' fees for misrepresentation upon the sale of the franchise under Indiana law).

<sup>33</sup> *Chase Manhattan Bank, N.A. v. Chusiau Sales & Rental, Inc.*, 308 N.W.2d 490 (Minn. 1981) (holding that a muffler dealer was entitled to rescind its lease because the dealership and lease had been offered in violation of the Minnesota Franchises Law).

<sup>34</sup> *Meadow Fresh Farms, Inc. v. Sandstrom*, 333 N.W.2d 780 (N.D. 1983) (granting the North Dakota Securities Commissioner a cease and desist order against the offering of distributorships for the sale of dry milk because they were deemed to be unregistered franchises in violation of the North Dakota Franchise Investment Law).

<sup>35</sup> *Lobdell v. Sugar 'N Spice, Inc.*, 33 Wash. App. 881, 658 P.2d 1267 (1983) (holding that a candy distributor was entitled to seek treble damages and attorneys' fees because its distributorship had been offered in violation of the Washington Franchise Investment Act).

<sup>36</sup> In *Chem-Tek, Inc. v. General Motors Corp.*, 816 F. Sup. 123 (D. Conn. 1993) (holding that the marketing plan element of the definition of a franchise was satisfied where GM, the licensor of a manufacturer of vehicle protection products, directed the employment of the licensee's marketing personnel and retained authority to approve or direct their termination; reimbursed salaries and expenses for marketing personnel; set the purchase price for the products; and prohibited the licensee from offering any competing products).

<sup>37</sup> Bus. Franchise Guide (CCH) ¶ 6207, 44 *Fed. Reg.* 49966 (Aug. 24, 1979).

<sup>38</sup> *Gentis v. Safeguard Bus. Sys., Inc.*, 60 Cal. App. 4th 1294, 71 Cal. Rptr. 2d 122 (1998).

<sup>39</sup>

SLAP [the distributor] was expected to develop a marketing plan, but to do so on their own. Whirlpool never dictated the form or content of a SLAP marketing plan. Furthermore, Whirlpool states that it had very little control over SLAP's decision-making process. SLAP had the right to sell Whirlpool parts to any buyer in the

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United States. SLAP also had the right to train their personnel in any manner that they chose. Finally, Whirlpool states that it could not dictate how SLAP was to manage its day-to-day operations.

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

<sup>40</sup> See *Consumers Petroleum of Connecticut, Inc. v. Duhan*, 38 Conn. Supp. 495, 452 A.2d 123, Bus. Franchise Guide (CCH) ¶7906 (Conn. Super. Ct. 1982).; *Narumanchi v. Shell Oil Co.*, Bus. Franchise Guide (CCH) ¶8720 (D. Conn. 1986). See also *Ackley v. Gulf Oil Corp.*, 726 F. Supp. 353 (D. Conn.), aff'd, 889 F.2d 1280 (2d Cir. 1989), cert. denied, 494 U.S. 1081 (1990); and *Koehler Enterprises, Inc. v. Shell Oil Co.*, Bus. Franchise Guide (CCH) ¶10,252 (D. Md. 1993); *Robert Sorisio, d/b/a Connecticut Handbag and Luggage Co. v. Lenox, Inc., successor to Hartmann Luggage Co.*, Bus. Franchise Guide (CCH) ¶9360 (D Conn. 1988).

<sup>41</sup> *Atlantic Richfield Co. v. Razumic*, 480 Pa. 366, 390 A.2d 736 (1978). *Arnott v. American Oil Co.*, 609 F.2d 873 (8th Cir. 1979), cert. denied, 446 U.S. 918, 100 S. Ct. 1852, 64 L. Ed. 2d 272 (1980); *Shell Oil Co. v. Marinello*, 63 N.J. 402, 307 A.2d 598 (1973), cert. denied, 415 U.S. 920, 94 S. Ct. 1421, 39 L. Ed. 2d 475 (1974).

<sup>42</sup> In *Jerome-Duncan, Inc. v. Auto-ByTel, LLC*, Bus. Franchise Guide (CCH) ¶11,667 (6<sup>th</sup> Cir., May 21, 1999), the dealer alleged that ABT could not terminate the agreement without good cause because the arrangement constituted a “franchise” under the Michigan Franchise Investment Law.

<sup>43</sup> *Account Services Corporation v. Dakcs Software Services, Inc.*, 208 Ill. App.3d 392, 398 (1990).

<sup>44</sup> Bus. Franchise Guide (CCH) ¶¶6495, 6477.

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Tom Pitegoff is the founder of Pitegoff Law Office, in White Plains, New York, a small firm offering high quality corporate counsel services to companies of all sizes, locally and internationally. The firm is known for its work in representing emerging technology companies and franchise companies. The firm also represents a number of foreign companies doing business in the U.S.

Tom has the highest rating available from Martindale-Hubbell. He is listed in WHO'SWHOLEGAL: THE INTERNATIONAL WHO'S WHO OF BUSINESS LAWYERS (London 2003). He is a member of the Executive Committee of the New York State Bar Association's Business Law Section. He is also a former member of the Governing Committee of the American Bar Association's Forum on Franchising (1993-1996), a former Associate Editor of the ABA FRANCHISE LAW JOURNAL (1990-1993), and the former Co-Chair of the International Subcommittee of the ABA Business Law Section's Cyberspace Law Committee (1998-2000). In addition, Tom is a panelist for the CPR Institute for Dispute Resolution, serving as an ICANN arbitrator for domain name disputes and as a franchise mediator.

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- *Franchise Relationship Laws: A Minefield for Franchisors*, 45 BUS. LAW. 289 (1989), reprinted in the ABA's BUILDING FRANCHISE RELATIONSHIPS (1996)
- *Choice of Law in Franchise Relationships: Staying Within Bounds*, 14 FRANCHISE L. J. 89 (Spring 1995)
- *Avoiding the Long Arm of the Law in International Franchising*, (ABA Forum on Franchising, October 1995) (co-authored with Andrew Loewinger)
- *Ways to Avoid Being a Franchise*, FRANCHISE L.J. (Fall 1992)

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