

The Inadvertent CyberFranchisor

By Thomas M. Pitegoff
White Plains, NY
www.pitlaw.com

*This article was first published in the April 1998 issue of CyberSpace Lawyer (Glasser LegalWorks).

Franchising means more than fast food. Federal and state laws define the term “franchise” in a way that can easily catch a licensor or manufacturer by surprise. With the proliferation of commerce on the Web, these laws can also entangle the unwary cyberbusiness. While I know of no reported case on the question of whether a Web service constitutes a “franchise”, it is only a matter of time before a court or administrator addresses the issue. Attorneys who counsel cyberbusinesses will want to know when their clients should be concerned about these laws.

The starting point for any discussion of what constitutes a franchise is an offer of a method of doing business. On the Internet, this can mean Web shopping malls, content providers, travel and real estate services, city and regional sites, search engines, and Web hosting services, among others. For the sake of simplicity, I will refer to these businesses as content providers or hosting services.

In most cases, Web content providers and hosting services will want to avoid the franchise laws. Franchise compliance is costly. At the outset, it 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. Noncompliance can lead to administrative actions and private lawsuits; with resulting penalties, damages, rescission and other remedies.

On the other hand, if a client’s planned business has the appearance of a franchise, it is often to the client’s advantage to accept that fact and to take the approach of a full-fledged franchisor. Compliance in this manner provides a safe harbor, meaning that the client need not be concerned about being an unwitting franchisor that has failed to disclose. It allows the client to act more freely with potential licensees or customers. First Internet, Triax and Quik Internet, for example, advertise themselves as franchisors.¹

Franchise Laws

The Federal Trade Commission trade regulation rule on franchising (the "FTC Rule") requires franchisors to deliver an offering circular to each prospective franchisee before the

prospective franchisee signs an agreement or pays the franchisor. While the FTC Rule applies throughout the U.S., it does not require registration, and 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.²

Roughly 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. Many of these states also require registration of the offer. Failure to comply with the state franchise laws can result in both administrative proceedings and private actions by franchisees for rescission, actual damages, injunctive or declaratory relief, attorneys' fees, and costs. Where the violation is willful, the states allow for punitive damages and criminal liability. The FTC Rule does not preempt the state franchise laws.

“Franchise” Defined

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.³

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 fee element is satisfied if the franchisee is required to make a payment to the franchisor (or an affiliate of the franchisor) 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.

Significant control may include requirements regarding the location of the franchised shop, site design or appearance, hours of operation, production techniques, accounting practices, personnel policies, customers or sales areas, or participation in promotional campaigns. Significant assistance may include training programs; accounting systems; management, marketing or personnel advice; selecting site locations; or furnishing a detailed operating manual.

As in the FTC Rule, the definitions of a "franchise" under most state franchise laws contain three elements.⁴ 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"

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.⁵ 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. Moreover, the New York franchise law can apply extraterritorially. The New York franchise law applies if the offer merely originates from New

York or is accepted in the state, regardless of where the franchisee or franchise business is located.

Varieties of Web Arrangements

A Web hosting service that offers Web shopping malls or the like to others in conjunction with the hosting service's trademark would be likely to satisfy the trademark requirement of the definition of a franchise under both the FTC Rule and state laws. Similarly, a content provider that requires its licensees to display the content provider's trademark on the licensees' Web pages would be likely to satisfy the trademark requirement. One step a hosting service or service provider can take to reduce the likelihood of satisfying the trademark requirement is to include a provision in the agreement expressly prohibiting the licensee's or customer's use of its trademark.

Any kind of royalty or service fee is likely to satisfy the fee requirement in the federal and state definitions of a franchise. Although there is a recognized exception for the sale of goods at a bona fide wholesale price for reasonable amounts of merchandise to be used for resale, there is no such exception for the sale of services or information. The FTC Rule excludes from the definition of a required fee payments of less than \$500 within the first six months from the start of the franchise operation, but there is no such exception under the state laws.

Because it is so easy to satisfy the trademark and fee elements of the definition of a franchise, many cases under the FTC Rule turn on the question of whether the "franchisor" exercises significant control or provides significant assistance. The control question is a difficult one in the context of a trademark license. A trademark licensor needs to exercise some quality control in order to protect the licensed trademark. It is difficult to know when this quality control becomes "significant" control under the FTC Rule. Many hosting services limit the ability of their customers to modify their sites. Some content providers also limit the context in which the content may be used. Generally speaking, the more control over the Web site that a hosting service or content provider allows its customers, the less the likelihood that the service or license offered will be a franchise under the FTC Rule.

In most cases, a franchise under the FTC Rule is also a franchise under the state franchise laws, and *vice versa*. However, this may not always be the case. A franchisor who provides significant assistance but makes that assistance optional may be a franchisor for purposes of the FTC Rule, but might not be a franchisor under state laws, because the assistance may not be "prescribed in substantial part" by the franchisor. In order to make this argument, the marketing plan would have to be entirely optional, leaving purchasers free to run their businesses as they see fit.

The California Commissioner of Corporations has stated that "The marketing plan or system prescribed by the franchisor is one of the important means by which the appearance of centralized management and uniform standards is achieved."⁶ In the context of a Web design and hosting service, this might mean that a marketing plan may exist when the hosted sites are so similar to one another that they have the appearance of a unified group of Web sites.

Banner Advertising and More

Web site owners frequently advertise their sites through banner advertising on third party Web sites. The advertiser sometimes pays the owner of the site that provides the advertising space based on the number of hits to the advertiser's site or the amount of money spent by sources referred from the site that provides the advertising space. Such advertising does not constitute a franchise.

Content providers on the Web can act like banner advertisers when the "content" is actually a link to the content provider's Web site. The arrangement might be structured so that the end user makes payments directly to the content provider, and not to the site on which the end user found the content provider's link. In this scenario, the content provider might pay a commission to the third party site owner based on referrals from the third party's site. Here, the licensee would be acting more like a commissioned sales representative than a franchisee. Sales representatives are generally held not to be franchisees.⁷

The franchise laws apply only when the licensee offers, sells or distributes goods or services. If the licensee does not sell anything, but only facilitates sales by the content provider to end users, the licensee is acting more like a sales representative than a seller. When the sales representative's sole function is to solicit orders for acceptance by the manufacturer, most courts and commentators have concluded that the sales representative is not "offering, selling or distributing" the manufacturer's goods. The same principle would apply when the company accepting the order is a Web content provider.

If the content provider goes a step further and offers a Web site design and hosting service with links to the content provider's site and charges a fee, the arrangement starts to look more like a franchise. Arguably, this should detract from the fact that the site owner is acting as a sales representative. Moreover, if the advertiser or content provider continues to pay for referrals based on banner advertisements alone and this payment is the same as the amount paid when the licensee uses the Web design and hosting services, the added fee for design and hosting might not actually be "required". The FTC Rule and state franchise laws do not apply when a fee is not truly required but is optional.⁸ Put another way, the fact that the banner advertisement alternative is available would be evidence that the payment would not be for the "right" to offer, sell or distribute the advertiser's services.⁹ Of course, the content provider would have to make it clear to prospective licensees that they have the option of receiving the same commissions by posting a banner link on their Web sites without purchasing the content provider's design and hosting services.

Exemptions

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 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. This exemption does not exist under the state laws.

Some states also have specific state exemptions. 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. New York also exempts certain offers directed to not more than two persons. Washington exempts sales to certain "accredited investors." Note that these exemptions may apply to the registration requirements, not the disclosure requirements. A state may also require a notice filing even if the exemption applies.

Business Opportunity Laws

The FTC Rule also applies not only to franchises, but also to business opportunities, such as sellers of rack displays and vending machines. Approximately half of the states have "business opportunity" laws. Like the franchise laws, the business opportunity laws contain disclosure requirements and sometimes require a filing. While these laws vary from state to state, they generally define a business opportunity broadly.¹⁰ 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.¹¹ 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.

A Web content provider or hosting service should 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 its position that it is not a business opportunity, the content provider or hosting service should also not represent that it 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.

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. In the case of Web content providers and hosting services, this would include any domain names that might be used as trademarks.

Unfair and Deceptive Practices

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.” Web businesses, like any other advertisers, must know that they can violate the FTC Act even if they are not selling franchises. A Web business, like any other, can guard itself against violation of Section 5 by scrupulously not making any misrepresentations and by affirmatively disclosing material risks when advertising or promoting sales.

All fifty states and the District of Columbia have enacted consumer protection statutes, most of which prohibit “unfair or deceptive practices” or the like. These laws are often referred to as “little FTC Acts”. Violations of the FTC Act will often also be violations of these laws.

Just as avoiding specific representations about the chance of success or the amount of money that one can earn helps avoid the business opportunity laws, it also reduces the risk of being found to be engaging in unfair or deceptive trade practices. A Web content provider or hosting service that offers a method of doing business should also scrupulously disclose all risks of the venture prominently in its sales literature, on line and in all other advertising, including fact that the company makes no representation regarding earnings. The company should explain fully all of the costs, including the necessity of spending money on advertising, while indicated what the advertising can cost.

Conclusion

Companies that offer others a method of doing business on the Web can either structure their businesses in such a way that they are not franchises or they can go the full disclosure route. What they cannot do is ignore the law, because their customers and competition will not ignore the law, nor will government administrators.

The FTC, for example, has taken an active interest in the Internet. Apart from franchising, the FTC is now looking into Web site policies regarding the collection of information from consumers and considering ways to protect consumers’ personal privacy. In the field of franchising, the FTC is looking into methods used on the Web to make the franchise disclosures required by the FTC Rule. State attorneys general and other state administrators have likewise taken an active interest in Web commerce. The FTC and its state counterparts are undoubtedly also following the development of new types of businesses on the Web, with an eye toward franchise law enforcement.

¹ See www.fifc.net; ftp.triax.com; www.quik.net. Other franchisors are using the Internet to advertise their businesses and those of their franchisees, to communicate with franchisees, and sometimes to sell franchises. See, e.g., www.fran-one.com.

² 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. It may also include consumer redress, which 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).)

³ 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:

(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."

⁴ 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:

"'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.”

⁵ 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.”

⁶ Comm. Op. No. 73/39F.

⁷ See *Keeney v. Kemper National Insurance Co.*, Bus. Franchise Guide (CCH) ¶11,172 (1997); *Patterson v. Ford Motor Co.*, Bus. Franchise Guide (CCH) ¶10,988 (1996); *Kolthoff v. Fernandez*, Bus. Franchise Guide (CCH) ¶10,985 (1996); *John Maye Co. v. Nordson Corp.*, Bus. Franchise Guide (CCH) ¶9984 (1992), affirming Bus. Franchise Guide (CCH) ¶9761 (1990); *Kornacki v. Norton Performance Plastics*, Bus. Franchise Guide (CCH) ¶9949 (1992); *EBI, Inc. v. Gator Industries, Inc.*, Bus. Franchise Guide (CCH) ¶8726 (1986); *Kent Jenkins Sales, Inc. v. Angelo Brothers Co.*, Bus. Franchise Guide (CCH) ¶8700 (1986); *Gonzalez v. Brown Group, Inc.*, 628 F. Supp. 436, Bus. Franchise Guide (CCH) ¶8587 (1985); *Wilburn v. Jack Cartwright, Inc.*, Bus. Franchise Guide (CCH) ¶8063; *Darche Associates, Inc. v. Beatrice Foods Co.*, Bus. Franchise Guide (CCH) ¶7870 (1981); and *Foerster, Inc. v. Atlas Metal Parts Co.*, Bus. Franchise Guide (CCH) ¶7754 (1981). *But see* *Blankenship v. Dialist International Corp.*, 568 N.E.2d 503, Bus. Franchise Guide (CCH) ¶9808 (1991); and *Gentis v. Safeguard Business Systems, Inc.*, Bus. Franchise Guide (CCH) ¶11,318 (1998).

⁸ The California Commissioner of Corporations has indicated that a truly optional fee is one that is not required, and therefore cannot be a “required fee” for purposes of the definition of a “franchise”:

“The Law does not include in the definition of ‘franchise fee’ payments which the franchisee is not required to make but which are optional and required only if the franchisee elects to purchase, lease or rent merchandise, equipment or other property from the franchisor or an affiliate of the franchisor. In the absence of an obligation or a condition in the franchise agreement compelling action on the franchisee’s part, or the necessity for undertaking such obligation in order to successfully operate the business, voluntary payments are not ‘required’ under the agreement and, therefore, are not included within the statutory definition of ‘franchise fee.’ Also, voluntary payments, presumably, are not made for the right to enter into a franchised business and for that reason do not come within the definition.” Bus. Franchise Guide (CCH), ¶15050.45.

Similarly, the FTC has stated as follows:

“In considering whether a payment is ‘optional’, the Commission will consider whether such payments are ‘required by practical necessity.’ Payments will be considered ‘optional’ if the licensee has a genuine and realistic opportunity to choose other sources, in the context of the particular industry and the community in which he or she chooses to conduct business. The choice must be real, legitimate, and practical.” FTC Informal Staff Advisory Opinion 93-12, January 28, 1994, Bus. Franchise Guide (CCH) ¶16456.

⁹ See, e.g., *Bakke Chiropractic Clinic v. Physicians Plus Insurance Corp.*, Bus. Franchise Guide (CCH) ¶11,296 (1997).

¹⁰ 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 were initially sold or leased or offered for sale or lease to the purchaser by the seller assisted marketing plan seller.”

¹¹ 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.