

## Ways to Avoid Being a Franchise

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A lawyer working in the area of licensing, distribution and franchising must be able to recognize a franchise when he or she sees it. Franchise sales compliance entails significant cost, time and effort. At the outset, it requires the preparation of a franchise agreement, audited financial statements for the last three years, a detailed offering circular, and registration in some states. As an ongoing matter, it requires timely delivery of the offering circular to all prospective franchisees, timely amendments of offering circulars and renewals of registrations, the filing of advertising in some states, and continuing audits. Non-compliance can lead to administrative actions and private lawsuits, with resulting penalties, damages, rescission and other remedies.



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Some clients cannot afford these costs or risks, and want to find a structure that will avoid both. Other clients may be getting started in franchising, looking for ways to keep their initial costs low. For still other clients, a proposed license or distribution arrangement may technically fall under the franchise laws, but full disclosure may be inappropriate and avoidable. For negotiated business transactions that occur only once, the added cost of franchise disclosure would be especially burdensome.

### The FTC Rule

The Federal Trade Commission's Rule on Franchising (FTC Rule) requires franchisors making franchise offers anywhere in the United States to make extensive disclosures to prospective franchisees. The FTC Rule does not require registration, and violation of the FTC Rule does not give rise to a private right of action.

The definition of a "franchise" under the FTC Rule includes three elements—a trademark, a fee, and significant control or assistance.

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.

### Avoiding the FTC Rule

Here are some ways that a supplier or licensor might avoid application of the FTC Rule:

1. Expressly prohibit the distributor's use of the supplier's trademark. This will work only when the brand name is not important in marketing.
2. 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.
3. Do not exercise significant control and give no assistance other than advertising and promotional assistance.
4. Grant a license of a trademark to a single licensee who manufactures the trademarked goods according to the licensor's specifications.
5. Approach dealers with established businesses and offer your product as an addition to the dealers' preexisting businesses. 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 percent of the dollar volume of the franchisee's projected gross sales within the reasonably foreseeable future.
6. For an offer by a U.S. company to a prospective franchisee outside the United States, explicitly exclude by contract the application of the FTC Rule. Note, however, that

it is not clear whether this contractual exclusion would be effective.

### State Laws

Several states have laws similar to the FTC Rule, requiring that extensive disclosures be made at the time a franchise is 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.

As in the FTC Rule, the definition of a "franchise" under most state franchise laws has three elements. The trademark and fee elements of the state laws are parallel to the FTC Rule; but instead of control or assistance, the state laws refer either to a marketing plan prescribed in substantial part by the franchisor or a community of interest between the franchisor and franchisee.

### Avoiding the State Laws

Here are some suggestions for a supplier or licensor who wants to avoid the state franchise registration and disclosure laws:

1. Explore specific state exemptions. For example, California exempts offers by a franchisor with a net worth of at least \$5 million 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 million. New York also exempts certain offers directed to not more than two persons. Washington exempts sales to certain "accredited investors." Note that these exemptions apply to the registration requirements, not the disclosure requirements. A state may also require a notice filing even if the exemption applies.

2. Do not assume that elimination of either the marketing plan element or the trademark element will avoid the franchise laws in all states. As long as a franchise fee is required, the New York franchise law covers arrangements that include either a prescribed marketing plan or the use of the franchisor's trademark.

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

4. Avoid offering franchises in any of the fifteen states that require 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.

5. Do not assume that making an offer to a franchisee in one state will avoid application of another state's franchise law. Some of these laws apply extraterritorially. The New York franchise law, for example, applies if the offer merely originates from New York or is accepted in the state. The California franchise disclosure law applies when the franchise agreement is signed in the state and the initial franchise fee is paid there.

6. Explicitly exclude by contract the application of a state franchise law which might apply but which the franchisor seeks to avoid. Since a contract provision that calls for the application of the laws of any state with a protective franchise law might invoke the application of that law without any other connection with the state, it is advisable specifically to except application of the franchise law of that state, even if that state's contract law is to apply. 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.

### Other Suggestions

Here are a few suggestions that apply to both the FTC Rule and the state franchise laws:

1. Refrain from charging any fees or royalties whatsoever, except for the sale of goods at a bona fide wholesale price for reasonable amounts of merchandise to be used for resale.

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specified county or counties, city or cities, or a part thereof, in which the business so sold, or that of said corporation, division, or subsidiary has been carried on, so long as the buyer, or any person deriving title to the goodwill or shares from him, carries on a like business therein. For the purposes of this section, "subsidiary" shall mean any corporation, a majority of whose voting shares are owned by the selling corporation.

27. See, e.g., Kaplan v. Nalpak Corp., 158 Cal.App.2d 197, 322 P.2d 226 (1958) (agreement to refrain competition was valid and enforceable not only in county where corporation had place of business but also counties in which it had customers to whom it made sales in substantial amounts).

28. See, e.g., Laird v. Steinmann, 97 Cal.App.2d 781, 218 P.2d 780 (1950) (held where seller sold industrial laundry business including good will and customer lists, and agreed not to compete in county for five years, covenant was not void or against public policy).

29. In Bosley Medical Group v. Abramson, 161 Cal.App.3d 284, 207 Cal. Rptr. 477 (1984), an agreement provided that if a physician left the medical corporation in which he practiced, he was required to resell his nine shares of medical group stock to the corporation, and he could not engage in a similar medical practice within certain counties for three years. *Id.* at 287. The court concluded that the restrictive covenant contained in the stock resale agreement was simply a sham to avoid the prohibitions of section 16600, and as such it was void and unenforceable under California law. *Id.* at 292.

30. Scott, 732 F. Supp. at 1041.

31. *Id.*

32. *Id.* at 1041 n.9.

33. See Krehl v. Baskin-Robbins Ice Cream Company, 664 F.2d 1348 (9th Cir. 1982) (citing Siegel v. Chicken Delight, Inc. 448 F.2d 43 (9th Cir. 1971) *cert. denied*, 405 U.S. 955, 92 S. Ct. 1173, 31 L.Ed.2d 232 (1972)) (trademark reflects goodwill and quality standard of enterprise it identifies).

34. California Business and Professions Code section 20999.1 provides that in the context of petroleum franchise agreements, a franchisor may not terminate or cancel an existing franchise for the purpose of enabling the franchisor to assume the franchisee's business unless the franchisor pays the franchisee for the value of its franchise, including "a reasonable amount for goodwill." Based on this statutory language, the California legislature has clearly recognized that the franchisee generates its own goodwill. See also Arnott v. American Oil Company, 609 F.2d 873 (8th Cir. 1979), *cert. denied*, 446 U.S. 918, 100 S. Ct. 1852, 64 L.Ed.2d 272 (1980) (franchisee builds goodwill of his own business).

35. Of course, this concern does not apply to franchisors who are engaged in an enterprise at a location such as an office building where there is little or no hazardous waste exposure.

36. 42 U.S.C.A. § 9601, *et seq.*

37. 42 U.S.C.A. § 9607, *et seq.* (West 1983 and Supp. 1988).

38. A more comprehensive treatment of this subject is beyond the scope of this article. See generally, Slap and Israel, Private CERCLA Litigation: How to Avoid? How to Handle It?, 25 REAL PROP., PROB. AND TR. J. 705 (Winter 1991); Baker and Shea, How to Avoid Environmental Liability in Business Transactions, 43 SW L. J. 957 (Feb. 1990); Richter, Does CERCLA Allow Private parties to Contractually Allocate Liability for Cleaning Up Contaminated Sites, 22 U. TOL. L. REV. 1065 (Summer 1991).

39. 144 Cal.App.3d 946, 193 Cal. Rptr. 80 (1983).

40. *Id.*

41. *Id.* at 949.

42. *Id.* at 953.

43. *Id.* at 954-55.

44. Carnival Cruise Lines, Inc. v. Shute, 111 S. Ct. 1522, 113 L.Ed.2d 622 (1991); F.W. Myers & Co., Inc. v. Gerald Industries, 577 N.Y.S.2d 741 (1991); Bear, Stearns & Co. v. Bennett, 938 F.2d 31 (2d Cir. 1991).

45. *Id.* at 1039.

46. *Id.*

47. *Id.* at 1041. But as the sword carries a double edged blade, so would an unfavorable foreign judgment bind the defeated franchisor in California. See generally, Silbrico Corp. v. Raanan, 170 Cal.App.3d 202, 216 Cal. Rptr.

201 (1985); Tyus v. Tyus, 160 Cal.App.3d 789, 206 Cal. Rptr. 817 (1984); Worldwide Imports, Inc. v. Bartell, 145 Cal.App.3d 1006, 193 Cal. Rptr. 830 (1983).

48. General Accident Ins. Co. v. Namesnik, 790 F.2d 1397, 1398 (9th Cir. 1986).

49. Worldwide Imports, Inc. v. Bartell, 145 Cal.App.3d 1006, 193 Cal. Rptr. 830 (1983); Tyus v. Tyus 160 Cal.App.3d 789, 206 Cal. Rptr. 817 (1984).

50. Silbrico, Corp. v. Raanan, 170 Cal.App.3d 202, 216 Cal. Rptr. 201 (1985).

51. See United Bank of Denver v. K & W Trucking Co., 147 Cal.App.3d 217, 195 Cal. Rptr. 49 (1983).

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## operations manual

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2. Open only company-owned stores. Although this is expensive, it 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.

3. Approach a company that has its own franchise or company-owned system in place and propose that such company adopt your product as an authorized addition to its franchise or distribution program. This can provide instant expansion at a low cost. This approach might qualify as a "fractional franchise" under the FTC Rule. If franchise compliance is required, the revenues from the deal may justify the compliance costs. One possible disadvantage of this approach is that the contracting company may require exclusivity.

4. If the proposed arrangement might arguably be a franchise, consider seeking advisory opinions 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 opinion.

5. Consider full compliance with the registration and disclosure requirements. The client whose business calls for a franchise system but who does not want to go the full disclosure route poses a particularly difficult problem. The client may maintain that his competitor does not use offering circulars. Why must he spend the money? The answer may be that the competitor is running a big risk. You might remind the client that although the role of a franchisor is costly, it is safe from a legal point of view and allows the client to exercise significant control. It is just possible that after a full analysis of the question, the client may decide that it is worthwhile not to avoid the franchise laws, but to go the full disclosure route. □