

## ROBERT G. HUTCHINS – LEGAL BULLETINS

### November 2004 – Franchise Alert – Proposed FTC Rule Amendments

Current franchise laws reflect a regulatory quagmire that can burden franchisors, frustrate franchisees and entangle some entirely unrelated businesses. There are several reasons for this:

- Section 5(a)(1) of the Federal Trade Commission Act prohibits the use in interstate commerce of “unfair methods of competition” or “unfair or deceptive acts or practices.” Section 5(a)(2) authorizes the FTC to enforce the prohibition. One result is the FTC’s Franchise Rule, which imposes exhaustive disclosure requirements upon interstate franchisors. Any franchise system using media, supplies or services that transcend or are delivered across state lines is deemed engaged in interstate commerce. Its franchisor is thus covered by the FTC Rule.
- A number of states have enacted franchise laws of their own. Others have business opportunity or consumer protection laws that reach franchise relationships. The state laws are not preempted by the FTC and they subject franchisors to both disclosure and conduct requirements.
- The North American Securities Administrators Association has adopted a Uniform Franchise Offering Circular that is a valuable disclosure guide, but it is neither uniformly accepted by the states nor entirely consistent with the disclosures required by the FTC. Accordingly, franchisors cannot use a single disclosure document in all jurisdictions.
- The FTC Rule requires that franchisors disclose relevant facts, but it does not interfere with their freedom of contract. State legislatures, by contrast, believe the bargaining power of franchisors to be disproportionately great and likely to be abused if not restrained. Their laws prevent franchisors from imposing “unreasonable” restrictions on such things as open market purchases of inventory, franchise transfers and competition in the franchised business. Since the perception of reasonableness can vary widely, the result is a hodgepodge of local rules regarded by franchisors as burdensome and by franchisees as ambiguous and ineffective.
- Franchise laws do not distinguish clearly between a franchise and other legal relationships that contemplate the commercial exploitation of a proprietary business method, product or service. Companies that engage distributors or license the use of intellectual property, for example, can become inadvertent statutory franchisors suddenly faced with an unfamiliar legal environment.

Well advised *intentional* franchisors can anticipate these problems when designing their programs. Careful franchisees can learn about them by reading disclosure documents and completing due diligence before they invest. The threshold question for many others, however, is whether their effort to distribute their products or license the use of their ideas will be regulated as a “franchise.” This Bulletin explores that question in light of the current and proposed FTC Rules and Washington’s Franchise Investment Protection Act.

#### **The Current FTC Definition**

The current FTC Rule contains a lengthy and convoluted definition of the term “franchise” that includes “package and product” franchises and “business opportunity” franchises. The definition has the following components:

- there is an *arrangement* for a *continuing commercial relationship*; that includes

- a *payment* (or payment commitment) that is *required* from one of the parties (the “franchisee”) for the *right to participate* in the relationship; plus
- the exercise (or authority to exercise) by the party receiving the payment (the “franchisor”) of *significant control* over the franchisee’s *method of operation* or the provision by the franchisor of *significant assistance* respecting that method; plus *either*:

(a) distribution by the franchisee (i) of a *product or service (a “package”)* identified by the franchisor’s *commercial symbol* or (ii) of an unmarked product or service, through a *business or operation* identified by the franchisor’s commercial symbol, where the product or service must conform to *quality standards required or suggested* by the franchisor, or

(b) distribution by the franchisee, *without using a commercial symbol*, of a *business opportunity*, comprised of an unmarked product or service supplied by the franchisor, or its designated supplier, *if* the franchisor supports the distribution by providing retail outlets, retail accounts or locations for vending machines or displays.

There are “exclusions” for arrangements that might otherwise satisfy the definition but are outside the intended scope of the Rule. There are “exemptions” for franchises that are clearly within the definition, but deemed relatively risk-free. The “exclusions” include employment relationships and general partnerships, cooperative organizations, testing services and “single” licenses. The exemptions include “fractional” franchises (the first year revenue from which is less than 20% of the total revenue of the franchisee), “leased departments” (involving sales by independent lessees or licensees operating from the premises of a retailer), oral franchises and franchises requiring payments of less than \$500 within the first six months.<sup>1</sup>

### **The Problem**

The current definition is subjective and ambiguous. It can include garden variety commercial relationships that are neither conceived nor marketed as a franchise. Equipment lessors, technology licensors and manufacturers often authorize lessees, licensees and distributors to use their commercial symbols. They regularly impose or suggest operating or quality standards, if for no other reason than to adhere to patent requirements or satisfy performance specifications. The underlying agreements always create a continuing commercial relationship and often feature marketing incentives based upon resale leads or customer lists. The counterparties to these agreements commit to make “payments” in the form of rents, royalties, or list prices. Yet no one would suggest seriously that a true lease, license or distributorship, *as such*, is a franchise.

### **The Proposed Amendments**

In a series of “advisory opinions,” the FTC staff has reduced the definitional elements for “package and product” franchises to three: (1) the franchisee’s distribution of goods or services “associated” with the franchisor’s trademark or trade name, (2) the franchisor’s exercise of significant control or provision of significant assistance and (3) payment within 6 months of the minimum \$500. The staff has not opined extensively on business opportunities, but adheres to

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<sup>1</sup> Not surprisingly, there have been numerous attempts to avoid the FTC Rule by delaying payment of the 501<sup>st</sup> dollar of the “franchise fee” for six months and one day. The tortured interpretations of the Rule used by the FTC staff to frustrate these attempts would be amusing were they not a continuing reminder of careless rule making.

the position that, even though no commercial symbol is used, a continuing commercial relationship creates a business opportunity franchise if, in effect, an investor distributes products or services supplied by a seller or by a suggested third party, the seller secures retail outlets or accounts for the investor and the investor makes the minimum payment commitment.<sup>2</sup>

On August 4, 2004, following a protracted review, the staff proposed a series of amendments of the FTC Rule. Comments will be accepted until November 12, 2004, but it is not clear when, or if, the Commission will act on the proposal. The amendments include a shortened definition that codifies the staff advisory opinions and eliminates “business opportunity” sales, which the staff believes should be covered by a separate rule:

*“Franchise” means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller represents, orally or in writing, that:*

- (1) The franchisee obtains the right to operate a business that is identified or associated with the franchisor’s trademark, or to offer, sell, or distribute goods, services or commodities that are identified or associated with the franchisor’s trademark;*
- (2) The franchisor exerts or has authority to exert a significant degree of control over the franchisee’s method of operation, or provides significant assistance in the franchisee’s method of operation; and*
- (3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.”*

If the amendments are adopted, the definition would still rely on subjective terms such as “identified,” “associated,” and “significant,” but its relative simplicity would be a welcome improvement over the current formulation.

### **The Washington Definitions - The Franchise Investment Protection Act**

The Washington Franchise Investment Protection Act, or “FIPA,” defines a franchise as an “agreement” (which may be informal) having characteristics similar, but not identical, to those emphasized by the FTC staff:

- One or more *grantees* (each a “franchisee”) is provided the right to offer or sell goods or services under a *marketing plan* that is *prescribed or suggested in substantial part* by the *grantor* (the “franchisor”).

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<sup>2</sup> The staff also takes the position that, if the qualifying elements are otherwise present, it does not matter whether a “package,” “product” or “business opportunity” franchisor acts directly or through an affiliate, i.e. an entity having a control relationship with the franchisor. That position is probably necessary in many cases to prevent evasion of the Rule, but it also may prevent a corporate parent from segregating a franchise subsidiary and its business from other holdings, even though the subsidiary itself would be treated as a separate entity for corporate law purposes.

- The business of offering or selling the goods or services is *substantially associated* with a commercial symbol that *designates, or is owned or licensed by* the franchisor.
- The franchisee is obligated by the agreement to pay a *franchise fee* for the right to engage in the symbolized business.

Though less verbose than its federal counterpart, the FIPA suffers just as much from its use of ambiguous descriptive terms. For example, FIPA's definition of the term "marketing plan" *begins* by including *any* "plan or system concerning an aspect of conducting business." That sweeping pronouncement is followed by examples, e.g. price specifications, discount plans, merchandising devices, sales techniques and promotional materials that are deprived of illustrative value by a catchall final clause that adds to the mix *any* "operational, managerial, technical, or financial guidelines or assistance." There are no definitions for the terms "suggested" or "substantially associated."

At first blush, the key factor under FIPA that would turn a licensing, distributorship or purchase agreement into a franchise agreement would be the payment of a "franchise fee." However, "franchise fee" is defined circuitously as any charge paid for the right to enter or continue a business under a "franchise agreement" and "franchise agreement" is not defined at all. Moreover, the FIPA's examples of a franchise fee include charges common to other business arrangements such as mandatory capital investments, royalties and the purchase price for required equipment or inventory.

There are exclusions for "bona fide" wholesale or retail sales, personal property leases and real estate leases, if consummated at "fair" market or rental value, and for certain trading stamps, but "bona fide" and "fair" are not separately defined. There are exemptions, but only for separately regulated endeavors such as bank credit card plans, certain insurance transactions and motor vehicle dealerships.

### **Recommendations**

If an arrangement for the distribution or use of marked goods, services or ideas is to avoid classification as a statutory franchise, the agreement that creates it must make certain things clear: the distributor or licensee is operating its core business independently, subject only to restrictions that prohibit misrepresentation, protect intellectual property or convey specifications, instructions for use or warranty limitations. The commercial symbols or other promotional materials involved do not suggest the sale of a franchise rather than a product, service or license. Payments, however labeled, reflect an underlying trading market and are free of a markup that could be viewed as the price for the arrangement itself.

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