



Guiding You Through the Legal Maze.SM

THE INADVERTENT FRANCHISOR

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A. BUSINESSES COVERED BY THE FTC FRANCHISE RULE

1. Two types of continuing commercial relationships are defined as a "franchise" and, thus, are covered by the FTC Franchise Rule.

(a) **Franchise** (business format or product format) - three (3) elements:

(i) The franchisee sells goods or services which meet the franchisor's quality standards and operates under the franchisor's marks or which are identified by the franchisor's mark;

(ii) The franchisor exercises significant control over, or gives the franchisee significant assistance in, the franchisee's method of operation; and

(iii) The franchisee is required to make a payment of \$500 or more to the franchisor or a person affiliated with the franchisor at any time before or within six months after the business opens (excluding the wholesale price of inventory).

(b) **Significant Control or Assistance.** The FTC Franchise Rule Interpretive Guides sets forth nine examples of significant types of controls and five examples of significant promises of assistance over the franchisee's entire method of operation.

Significant Types of Control:

- (i) Site approval for unestablished business;
- (ii) Site design or appearance requirements;
- (iii) Hours of operation;
- (iv) Production techniques;
- (v) Accounting practices;
- (vi) Personnel policies and practices;
- (vii) Promotional campaigns requiring the franchisee's participation or financial contribution;
- (viii) Restrictions on customers; or
- (ix) Location or sales area restriction.

Significant Types of Promises of Assistance to the Franchisee's Method of Operation:

- (i) Formal sales, repair or business training programs;
- (ii) Establishing accounting systems;
- (iii) Furnishing management, marketing or personnel advice;
- (iv) Selecting site locations; or
- (v) Furnishing a detailed operating manual.

In addition to the above listed elements - the presence of any of which would suggest the existence of "significant control or assistance" the following additional elements will, to a lesser extent, be considered when determining whether "significant" control or assistance is present in a relationship:

- (i) A requirement that a franchisee service or repair a product (except warranty work);
- (ii) Inventory controls;
- (iii) Required displays of goods; or
- (iv) On-the-job assistance in sales or repairs.

The following elements are not considered in determining whether "significant" control or assistance exists:

- (i) Trademark controls designed solely to protect the trademark owner's legal ownership rights in the mark under Federal and state trademark laws (such as display of the mark or right of inspection);
- (ii) Health or safety restrictions required by Federal or state laws or regulations;
- (iii) Agreements between a retailer and a trading stamp company providing for the distribution of trading stamps in connection with retail sales of merchandise or service;
- (iv) Agreements between a bank credit interchange organization and retailers or member banks for the provision of credit cards and credit services; and
- (v) Assisting distributors in obtaining financing to be able to transact business.

(c) Relationships covered by the FTC Franchise Rule include those which are within either definition of "franchise" and those which are represented as being within the definition when the relationship is entered into, regardless of whether, in fact, they are within the definition.

B. EXEMPTIONS AND EXCLUSIONS FROM THE FTC FRANCHISE RULE

1. Exempt Relationships.

- (a) fractional franchises;
- (b) leased department arrangements; and
- (c) purely verbal arrangements.

2. Excluded Relationships.

- (a) employer/employee;
- (b) general business partners (not a limited partnership);
- (c) membership in retailer-owned cooperatives;
- (d) certification and testing services; and
- (e) single trademark licenses.

C. DEFINITION OF "FRANCHISE" UNDER STATE LAWS.

1. It is possible to structure yourself to not be a "franchise" under the FTC Franchise Rule but you still may be a "franchise" under certain state laws because of a broader definition of "franchise" under state law.

(a) The 15 state franchise disclosure laws define "franchise" in terms of a combination of three or four of six elements:

- (i) the franchise agreement itself (oral or written);
- (ii) the right to sell the franchisor's goods or services;
- (iii) a community of interest between the franchisor and the franchisee;
- (iv) a marketing plan or system prescribed or suggested by the franchisor;
- (v) the franchisor's substantial participation in the franchisee's business;
- (vi) the franchisee's substantial association with the franchisor's trademark; or
- (vii) the franchise fee (some states - no minimum or less than \$500).

(b) California, Illinois, Indiana, Maryland, North Dakota, Oregon, Rhode Island, Virginia, Washington and Wisconsin define a franchise as a combination in which the franchisee:

- (i) operates under a marketing plan or system prescribed in substantial part by the franchisor;
- (ii) is substantially associated with the franchisor's trademark or other commercial symbol designating the franchisor; and
- (iii) pays, directly or indirectly, a franchise fee.

(c) Hawaii, Minnesota and South Dakota define a franchise relationship in which the franchisee:

- (i) has a community of interest with the franchisor;
- (ii) has the right to use the franchisor's trademark or other commercial symbol; and
- (iii) pays, directly or indirectly, a franchise fee.

(d) Michigan and New York each require:

- (i) a marketing plan or system or substantial association with the franchisor's trademark; and
- (ii) payment of a franchise fee.

2. Therefore, in structuring a business relationship to fall outside the definition of a "franchise," the FTC Franchise Rule must be reviewed as well as the laws of the state in which you intend to do business and the state of residence of the other person (franchisee).

D. THE INADVERTENT FRANCHISOR

Many types of business relationships may inadvertently become franchises because the elements of a franchise are present, notwithstanding the intention of the parties or the label of the relationship.

1. Distributorships/Dealerships.

(a) **Definition.** A distributorship/dealership is a marketing format whereby independent business persons take on certain wholesale ("distributor") and retail ("dealer") marketing, advertising, inventory, selling and/or servicing functions of a manufacturer to better promote and sell such manufacturer's products. A distributorship is generally characterized as a business relationship in which a distributor has the right to distribute products of a manufacturer or manufacturers. The distributor may carry a single line or multiple lines of one or more manufacturers who may be in competition with one another. A dealer is similar to a distributorship. The difference is that a dealership often obtains its products from a distributor rather than a manufacturer, and resells to the public from a retail outlet rather than to other dealers from a wholesale outlet. These descriptions

are somewhat simplified; in practice, elements of distributorships and dealerships may be combined in a business relationship. Further, these labels are often used interchangeably.

(b) **Pitfalls.** To avoid being a franchise several things may be considered such as:

- (i) No fee for the right to sell the supplied product;
- (ii) No significant assistance and/or control; and
- (iii) Dealer cannot use trademark.

2. **Trademark Licenses.**

(a) **Definition.** A license is the right of a person ("licensee") to use, for the payment of a fee and/or royalty, a patent, trademark, trade name, service mark or copyright owned by another ("licensor") in connection with the manufacture and/or sale of a product or rendition of a service.

(b) **Pitfalls.** Two of the elements of a franchise (use of a trade name and payment of a fee) are usually present. However, the licensor usually does not provide a marketing system or plan in connection with the product or service for which the trademark is licensed. There is a "twilight zone" between a licensor "policing" its trademark and providing significant assistance and/or control of the licensee.

3. **Partnerships and Joint Ventures.**

(a) **Definition.** A partnership is an association of two or more persons to carry on a business for profit as co-owners. A joint venture is a partnership organized to carry out a limited or specific purpose. Sometimes there are two companies involved at the same or at different levels of the value chain (*e.g.*, capital/labor; manufacturer/retailer) whereby there may exist certain synergies in working together either as a joint venture or as a partnership.

(b) **Pitfalls.** While a joint venture or a general partnership is excluded from the definition of a franchise under the FTC Franchise Rule, where a company (franchisor) develops a partnership (holding its partnership interest in a subsidiary or affiliated corporation) for each outlet of distribution, contributes a license of its trade name and marketing plan and receives any fee (*e.g.*, training) the relationship may be considered a franchise.

4. **Employer/Employee.**

Where the employer requires the employee to "invest" in the outlet of distribution in which the employee will manage and share in its profits, the arrangement may be considered a franchise.

5. **Corporation.**

The use of forming a corporation for each outlet of distribution owned jointly by the person contributing a license of its name and market plan and a person contributing money and his or her labor will not fall within the general partnership exemption and may be considered a franchise.

6. **Sale of Business.**

Generally, the sale of business including the name of the business is not a sale of a franchise. If the seller retains ownership of the name and merely licenses or permits the buyer to use the name and offers the buyer a marketing plan or significant assistance or control after the sale, the sale may be considered a sale of a franchise.

7. **Sales Representative.**

(a) **Definition.** A sales representative is a person acting as an independent contractor to sell goods or services on behalf of a manufacturer or distributor. Usually, the sales representative pays no fee to become a representative, does not take title to the goods and does not operate under the manufacturer's or distributor's trade name.

(b) **Pitfalls.** If the sales representative sells or distributes products under a marketing plan prescribed by the manufacturer, uses the manufacturer's trade name and paid the manufacturer a fee for the right to engage in business, the relationship may be considered a "franchise."

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