United States

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Introduction

Franchising in some form has been a part of the American business landscape since the mid 1800s.[1] It blossomed in the 1950s and 1960s when small companies such as McDonalds, Midas Muffler, and others expanded their reach by offering franchising as a business model. History has proven that these early advocates were on the right track, as they have become giants in their industry sectors. Entrepreneurs quickly learned that the franchise business model was a viable way reach a large audience and to enhance the identity of their products, trade marks, and logos.

On a national basis, the Federal Trade Commission (FTC) regulates the franchise industry, with part of its regulatory scheme being the Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities (the "Revised Rule").[2]

Generally, a franchise is: any continuing commercial relationship or arrangement in which the franchisee obtains the right to operate a business that uses or is otherwise identified with the franchisor's trade marks; the franchisor exerts significant control over, or provides significant direction to, the franchisee; and the franchisee pays money or money equivalent to the franchisor within a defined period of time.[3]

Environment

Attitude of State and Federal Government toward Foreign Enterprises

The United States welcomes foreign investment and business development. There is no federal registration of foreign business entities. Instead, it is left to

1 I. M. Singer of the Singer sewing machine company is often credited with creating the first recognizable franchise system in the 1850s. Daszkowski, *What is a Franchise: The Definition of Franchise*; About.com at http://franchises.about.com/od/franchise basics/a/what-franchises.htm.
2 Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities, 16 Code of Federal Regulations, Section 436 (2007).
3 16 Code of Federal Regulations, Section 436.1(h) (2007).

the individual states to regulate the operation of a foreign business entity within its borders.

Typically, this means that the foreign entity must demonstrate that it is properly organized as a business entity in the jurisdiction in which it was formed, must fill out the appropriate state forms, and must then pay a registration fee.

Sectors of the Economy Restricted for Foreign Enterprises

From a franchisor's point of view, the United States places no unusual barriers to foreign entities that wish to offer franchises. There are, however, sectors of the economy in which participation by foreign entities may be limited. The United States Constitution grants the Congress of the United States the exclusive power to ". . . regulate commerce with foreign Nations and among the several states".[4]

Thus, there are a myriad of regulations that govern a foreign business entity's operation of, and investment in, certain business sectors that are of strategic or national security importance. These industries include the maritime, aircraft, banking, natural resource, power, defense, and other industries that are parties to government contracts.

For instance, in the shipping area, there are restrictions on foreign ownership of vessels carrying the flag of the United States.[5] Similarly, only vessels built in the United States and documented under United States law can ply the coastal trade between states.

In the banking arena, the International Banking Act of 1978[6] provides the primary statutory framework that governs the participation of a foreign entity in the banking or lending sectors. A foreign bank may establish a "branch" or "agency" in the United States or may acquire an ownership interest in a bank or commercial lender only with the approval of the Comptroller of the United States.[7]

When making this determination, the Comptroller will confer with the Governors of the Federal Reserve System[8] (Board) and any conditions imposed by the Board must be satisfied by the applicant.

There also are numerous regulations that are not industry-specific, but which govern a foreign business entity's operation and investment in the United States. The National Industrial Security Program[9] was promulgated to protect classified

4 United States Constitution, Article I, Section 8, Clause 3.
5 Shipping Act of 1916, 46A United States Code, Section 23 (1983); Merchant Marine Act of 1928, 46A United States Code, Section 24A (1970) and the Merchant Marine Act of 1936, 46A United States Code, Section 27 (1970).
6 International Banking Act of 1978, 12 United States Code, Section 3101 (1978).
7 12 United States Code, Section 3102(a)(1) (1978).
8 12 United States Code, Section 3102 (1978).
9 This program was established in 1993 by the President's Executive Order 12829 (Executive Order Number 12829, 58 Code of Federal Regulations 3479 (1993), as amended by Executive Order, Number 12885, 58 Code of Federal Regulations 65863 (1993)).

information that is released to contractors (including foreign contractors) working for the United States government.

There also is the "Buy America Act" (BAA) that was originally passed in 1933.[10] It established the basic structure used by the federal government in order to encourage the purchase of domestic goods and services. Although the BAA has significant loopholes,[11] it was revitalized under the American Recovery and Reinvestment Act of 2009[12] (ARRA), when Congress decreed that funds under the ARRA could not be used for: ". . . a project for the construction, alteration, maintenance, or repair of a public building or public work unless all of the iron, steel, and manufactured goods used in the project are produced in the United States".[13]

Not surprisingly, the United States also imposes restrictions on government contracts with foreign entities where such contracts would involve national security concerns. Thus, the United States Department of Defense (DOD) and the Department of Energy (DOE) each are prohibited from contracting with any foreign entity where a "proscribed category of information" is at issue.[14]

The categories of such information for the DOD include: special access information (meaning secret information); information that may be in the security interests of the United States to remain secret; or information that is otherwise identified as being such information by the Secretary of Defense.[15]

For the DOE, such information includes information that may be considered to be of national security interest and information that the Secretary of Energy deems to fall within this category.[16] The United States also prohibits transactions with any foreign person, business entity, or country that supports terrorism.[17]

Investment Incentives Available to Foreign Enterprises

In the United States, for the most part, investment incentives are determined on a state or local level and not by the federal government. Such incentives include

10 Buy America Act, 41 United States Code, Section 10a-10d (1996).

11 For instance, the BAA does not apply when it is determined that the quantity and quality of domestic goods are insufficient (41 United States Code, Section 10a); more importantly, it does not apply when it is determined that the cost of the domestic goods are "unreasonable" (41 United States Code, Sections 10a and 10d).

12 American Recovery and Reinvestment Act of 2009, Public Law Number 111-5, 123 Stat. 115, see http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1enr.pdf.

13 American Recovery and Reinvestment Act of 2009, Section 1605(a), see http://loanprograms.energy.gov/wp-content/uploads/2010/09/Sect1605ARRA.pdf.

14 10 United States Code, Section 2536(a).

15 10 United States Code, Section 2536(c)(2)(A).

16 10 United States Code, Section 2536(c)(2)(B).

17 10 United States Code, Section 2357; Executive Order 13224 (23 September 2001). The United States Department of State makes such designations. The current list of such state sponsors of terrorism includes Cuba, Iran, North Korea, Sudan, and Syria. See http://www.state.gov/j/ct/rls/other/des/122570.htm.

tax breaks for the development of manufacturing facilities in a particular state, and partnerships between the foreign entity and the state or municipality for the development of job-creating businesses.

As each state, and indeed as each separate municipality, may have available such incentives, it is impossible to list them here. Location USA is a guide that helps foreign investors navigate the incentive landscape.[18] This site is sponsored by various states and can provide helpful information for the interested investor.

Exchange Controls and Regulations

Generally, "foreign exchange controls" are regulations imposed by the central government on the purchase or sale of local or foreign currencies in its country.[19] The United States has what many view as exchange controls that were included in a 2010 law.

In the Hiring Incentives to Restore Employment Act,[20] a law passed to stimulate state-side job growth, United States financial assets held by any foreign bank on behalf of a United States citizen who refuses to disclose such assets (including the balance held and all deposits and withdrawals) will now be required to withhold 30 per cent of such asset pending a United States tax. Americans who fail to disclose such assets will be assessed a penalty equal to 40 per cent of such assets.

Extent to Which Franchising is a Common Form of Enterprise

Franchising as an industry is a significant engine of capital growth in the United States. The International Franchise Association (IFA), through the IFA Educational Foundation,[21] has estimated that franchised businesses directly account for some 11-million jobs with a payroll of approximately US $278-billion, which is approximately five per cent of the payroll for the entire private sector of American businesses.[22]

There are approximately 909,000 franchised business establishments.[23] When one takes into account the number of ancillary jobs and revenue generated to service the franchise sector, an additional 20-million jobs are created which generate a payroll of more than US $660-billion.[24] The growth of franchise jobs

18 See http://www.locationusa.com.

19 See http://www.investopedia.com/terms/e/exchangecontrol.asp.

20 Pub. L. 111-147, 124 Stat. 71.

21 The IFA Educational Foundation funded a study, *Economic Impact of Franchised Businesses*, which was completed by Price Waterhouse Cooper in 2008, see http://www.franchise.org/franchiseesecondary.aspx?id=37842. This data is complete through 2005, which is the last year of such compilation.

22 IFA Educational Foundation, Economic Impact of Franchised Businesses, see http://www.franchise.org/franchiseesecondary.aspx?id=37842.

23 IFA Educational Foundation, Economic Impact of Franchised Businesses, see http://www.franchise.org/franchiseesecondary.aspx?id=37842.

24 IFA Educational Foundation, Economic Impact of Franchised Businesses, see http://www.franchise.org/franchiseesecondary.aspx?id=37842.

is expected to continue its four-year pace of about 2.9 per cent as compared to overall economy whose growth is approximately 2.4 per cent.[25]

In the United States, the number of franchise systems (each with its own brand) fluctuates between 2,500 and 3,000 each year.[26] The number of categories into which such systems fall is estimated at approximately 100.[27] The best source for the list of such entities is the IFA's annual *Franchise Opportunities Guide*.[28]

Financing of Franchises

The worldwide financial contraction that began in earnest in 2008 continues in 2015 to restrict the access to capital for both franchisors and prospective and current franchisees. As a result, by some industry estimates, the sale of franchises for the calendar year 2010 was down by 50 per cent over the same period for 2007.[29]

Generally, in the United States, a franchise opportunity can cost the franchisee between US $10,000 for a small home-based business, to literally millions of dollars to open the business[30] and, for the most part, the prospective franchisee must find financing to cover such costs.

One of the most important tasks that a prospective franchisee can undertake is the preparation of a business plan to guide the funding process and the subsequent operation of the business. A foundational piece of the plan will always be the financial projections and assumptions made by the prospect to determine whether the venture will be profitable. In the purchase of any other type of business, the prospect would query the seller to get historical profit, loss, and balance sheet information that could then be plugged into a *pro forma* financial projection. Franchising is unique in that the seller, the franchisor, cannot provide the purchaser (the prospective franchisee) with any financial data

25 IFA Educational Foundation Franchise Business Economic Outlook for 2015. The entire can be downloaded at: http://www.franchise.org/franchise-businesses-projected-to-again-grow-faster-than-the-rest-of-the-economy-in-2015. Then hit the hyperlink "HERE" found towards the bottom of the page.

26 Johnson, "Franchising Continues to Grow Across the United States", *Franchising World* (1 November 2007), see http://www.allbusiness.com/food-beverage/restaurants- food-service-restaurants-fast/5504171-1.html. This is an estimate only, and was developed based on information from the IFA and FranData, an independent franchise data collection company (FranData.com).

27 IFA Educational Foundation, Economic Impact of Franchised Businesses, see http://www.franchise.org/uploadedFiles/Franchisors/Other_Content/economic_impact_documents/IndustryCategories.pdf.

28 The Franchise Opportunities Guide can be ordered by contacting the Publication Sales department of the IFA at Publication Sales, International Franchise Association, 1501 K Street, NW, Suite 350, Washington, DC 20005 (800-543-1038); or by going online to http://franchise.org/franchises.aspx.

29 The IFA has stated: "We believe that lending to franchise businesses in 2010 was down 40 to 50 per cent", http://www.franchise.org/Franchise-News-Detail.aspx?id=52727.

30 See http://www.franchise.org/franchises.aspx.

or projections unless the same is formalized into the so-called "Financial Performance Representation" (FPR) and disclosed at Item 19 of the FDD.

Approximately 30 to 40 per cent[31] of all franchisors provide such earnings claims,[32] which means that a vast majority of franchisors will be unable to discuss the financial characteristics of the business to be purchased. Since the franchisor is required to provide prospective franchisees with a list of its current and past franchisees,[33] the best source for financial information will be those groups. Unlike the franchisor, there are no restrictions on what can be disclosed by franchisees, including the financial status of the franchisee's business. Often, this source of information is then used by the prospective franchisee in his loan application process.

Notwithstanding the foregoing, the FTC has promulgated an "informal staff advisory opinion"[34] concerning the dissemination by a franchisor to a prospective lender of otherwise prohibited financial performance information.[35] Here, the FTC has stated that, under the old Rule, a franchisor was permitted to ". . . provide earning information directly to loan officials at a specific lending institution in connection with a *bona fide* loan application submitted by a prospective franchisee without triggering the Rule's earning claim [the precursor to the FPR] disclosure obligations".[36] This opinion has not been rescinded or withdrawn. Thus, to the extent that the franchisor provides financial performance information directly to the prospect's lender with an assurance from the lender that it will not disclose the same to the prospective franchisee, the same will not likely be a violation of the Revised Rule. Under normal lending policies, however, it is usual for the borrower to review the entire loan package which in turn would most likely contain such earnings information. As a result, inadvertent though it may be, disclosure to the franchisee has been

31 Based on an industry-wide estimate.

32 See Bond, *How Much Can I Make* (2015) Source Book Publications which collects FPRs in one book.

33 16 Code of Federal Regulations, Section 436.5(t)(4-5) (2007).

34 From time to time, the staff of the FTC will issue an informal staff advisory opinion when: (i) it is requested to do so by an applicant (who may be a franchisor, franchisee, prospective franchisee, or the general public) and (ii) the application provides sufficient factual information and a distinct question that can be answered. The response by the FTC is specific to that applicant only and can be withdrawn at any time. Each such opinion, however, does provide the reader with insight into how the staff of the FTC will respond. Informal Staff Advisory Opinions are specifically permitted pursuant to 16 Code of Federal Regulations, Section 1.3. The franchise-based opinions are gathered at http://business.ftc.gov/legal-resources/franchise-rule-staff-advisory-opinions and in the Business Franchise Guide, a subscription-based treatise prepared and distributed by Commerce Clearing House (cited as "Business Franchise Guide (CCH)").

35 Information Staff Advisory Opinion 97-3 (1997), see http://www.ftc.gov/bcp/franchise/advops/advis97-3.shtm.

36 Information Staff Advisory Opinion 97-3 (1997), see http://www.ftc.gov/bcp/franchise/advops/advis97-3.shtm.

made for which the franchisor could be held liable. As a result, this disclosure opportunity is rarely taken.

As a way of stimulating lending, the United States Small Business Administration (SBA) has in the past and will continue to guaranty bank loans to franchisee borrowers if the loans are made using the underwriting criteria of the SBA.[37] To obtain the guaranty, the borrower must first approach his local bank with his loan application. If the proposal meets both the bank and SBA loan criteria, and is approved by the bank and the SBA, the loan will be made to the borrower by the bank with the understanding that if the borrower fails to repay the loan, a portion of the loss to the bank will be made up by SBA funds. The two major lending programs administered by the SBA include the "7(a)" and "504" loan programs.

The 7(a) program will guaranty bank loans the proceeds of which can be used to purchase land, buildings, equipment, furniture, fixtures, equipment, or an existing business.[38] The 504 program provides the borrower with a guaranty for loans to be used for long-term fixed-rate financing.[39] Although SBA guarantees have been a significant stimulant for franchise purchases, tight financial markets continue to impede the bank-side approval of such loans, thereby making moot the value of the SBA guaranty.

In the United States, a prospective franchisee also has the limited right to tap into his qualified retirement plan to "borrow" the funds necessary for the purchase and operation of a franchise.[40] Although a complex undertaking, there are several companies that specialize in designing the plan necessary to tap into funds that otherwise would be subject to a sizable penalty and taxes for early withdrawal.[41] This has become more common and, for qualified individuals, is a reasonable alternative to traditional lending avenues. The retirement plans that qualify include a 401(k) administered by an employer, a self-directed 401(k),[42] an individual retirement account (IRA), or a profit-sharing or annuity plan. The basic procedure

37 See http://www.sba.gov/category/navigation-structure/loans-grants/small-business-loans/sba-loan-programs/sba-loan-queue.

38 American Recovery and Reinvestment Act of 2009, Public Law Number 111-5, 123 Stat. 115, Section 501, see http://www.sba.gov/category/navigation-structure/loans-grants/small-business-loans/sba-loan-programs/7a-loan-program.

39 American Recovery and Reinvestment Act of 2009, Public Law Number 111-5, 123 Stat. 115, Section 502; see http://www.sba.gov/content/cdc504-loan-program.

40 With the passage of the Employee Retirement Income Security Act (29 United States Code 18) (ERISA) in 1974, Congress provided both individuals and business entities the opportunity to set aside a portion of one's income into a retirement account that would realize deferred taxation of the investment until withdrawn. There is a good explanation of ERISA at http://en.wikipedia.org/wiki/Employee_Retirement_Income_Security_Act.

41 See http://www.guidantfinancial.com; www.benetrends.com.

42 A "401(k)" is a form of long-term savings plan that is operated by an employer on behalf of its employees or that can be controlled directly ("self-directed) by the person. It was formalized at Section 401, Subsection (k), of the Internal Revenue Code found at http://www.irs.gov/retirement/article/0,,id=120298,00.html.

is to first set up a sub-Chapter "c" corporation.[43] The new entity then sponsors a self-directed 401(k) plan that will be permitted to invest into the new corporation. Next, the prospective franchisee will move his retirement funds into the new plan. Finally, the plan purchases an equity position in the new corporation that, in turn, will have the revenue to purchase the franchise business.

Franchise-Specific Regulation

Franchise Regulation

Franchisors in the United States work under what may be the most complete scheme of governmental regulation in the world. In 1979, the FTC was charged by the United States Congress with the task of policing franchising at the national level.[44]

At that time, it promulgated a law entitled Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures (the "Rule"). In 2007, after 12 years of work, the FTC revised the Rule with what is sometimes called the "Revised Rule".[45]

In addition, the franchisor must consider the registration and disclosure statutes, rules, and regulations of some 15 states, with three more states requiring a form of exemption filing.[46] Often called the "registration states," each one has a separate statutory system that relates specifically to franchising.[47] In the registration states, the franchisor must comply with the Revised Rule and with the state-based statutes. In the "non-registration states",[48] the franchisor is required to abide only by the Revised Rule. The practical consequence of this is to provide the prospective franchisee with the greatest protection available. As is noted in the "Statement of Basis and Purpose" (SBP)[49] for the Revised Rule:

43 The name refers to the Chapter "c" of Chapter 1 of the Internal Revenue Code at 26 United States Code, Sections 301 *et seq.* A Sub-Chapter c corporation is subject to double taxation of the same dollar: first, the corporation is taxed on its revenue; next, the shareholder is taxed when the corporation makes a distribution or issues a dividend.

44 The FTC was given such power under Section 5 of the Federal Trade Commission Act, which is found at 15 United States Code, Section 45.

45 The old Rule was found at 16 Code of Federal Regulations, Section 426.1. The Revised Rule is found at 16 Code of Federal Regulations, Section 426 (2007).

46 See Table 1 for a complete list of the states and the corresponding statutes.

47 Most registration states require the prospective franchisor to deliver a uniform application, a filing fee (which may range from US $25 to US $750), and the FDD. The documents will then be subject to an in-depth review from which comments and changes to the document are often required.

48 Non-registration states are those states that have no franchise-based regulation. Note however, that as with any other contract, statutory or common law rights and duties of the franchisor will still apply.

49 72 Federal Regulations, Number 61,15444. The SBP sets forth in detail the FTC's rationale behind, and explanation of, the Revised Rule. This volume of the Federal Register can be found at http://edocket.access.gpo.gov/2007/pdf/E7-5829.pdf.

The FTC does not intend to preempt the franchise practice laws of any state or local government, except to the extent of any inconsistency with this Rule. A law is not inconsistent with this Rule if it affords prospective franchisees equal or greater protection, such as registration of disclosure documents or more extensive disclosures.[50]

The Revised Rules will, however, and in limited circumstances preempt a conflicting state law only to the extent that the state law ". . . stands as an obstacle to the accomplishments and execution of the full purpose and objectives of congress".[51]

In all cases, each "Franchisor"[52] must draft a multi-part disclosure document called the "Franchise Disclosure Document" (FDD) that may range in size from 50 pages to ones that span several hundred pages.

Although the federal government at one time defined the format of the old version of the FDD (the "Uniform Franchise Offering Circular" or "UFOC"), under the Revised Rule, it has adopted the disclosure format promulgated by the North American Securities Administrators Association (NASAA).[53] The FDD contains several parts that will be discussed below.

Prior to undertaking even drafting of this complex document, one must determine whether the opportunity being offered is in fact a franchise. The Revised Rule defines a "franchise" as follows:

> ". . . 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 promises or represents, orally or in writing, that:

50 72 Federal Regulations, Number 61, at p. 15537, first column. This volume of the Federal Register can be found at http://edocket.access.gpo.gov/2007/pdf/E7-5829.pdf.

51 72 Federal Regulations, Number 61, at p. 15537, third column. *English v. General Electric*, 496 US 72, at p. 79 (1990) (In this case, a North Carolina woman who worked in a nuclear plant as a lab technician complained to the plant operator, General Electric, that it had violated several safety standards. For her efforts, she was fired. As part of her complaint in federal court, she alleged a state-based tort of emotional distress. Although the court agreed that she had a viable state-based tort claim, it nonetheless struck down her right to bring such action since anything having to do with nuclear power was preempted by the federal government's unfettered control of nuclear power. Cited with approval by the FTC). See http://edocket.access.gpo.gov/2007/pdf/E7-5829.pdf. *Owens v. Pepsi*, 412 SE 2d. 636 (NC 1992).

52 The Revised Rule defines a "Franchisor" as: "any person who grants a franchise and participates in the franchise relationship". 16 Code of Federal Regulations, Section 436.1(k) (2007).

53 See http://www.nasaa.org. The original UFOC format was created by the Midwest Securities Commissioners Association in 1974. This eventually became the form adopted by NASAA. The interim guidelines for the NASAA format can be found at http://www.nasaa.org/wp-content/uploads/2011/08/6-2008UFOC.pdf. The FTC also has promulgated its own guidelines for the preparation of the FDD. See http://business.ftc.gov/legal-resources/franchise-rule-compliance-guide.

> "(1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trade mark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trade mark;
>
> "(2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide 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."[54]

The Revised Rule makes it clear that the business relationship between the parties, at least in the non-registration states, will be deemed to be a franchise only if it meets all three elements.[55]

In some cases, however, specific state regulations will define a "franchise" differently and more expansively. For instance, New York, which is a merit review and registration state, defines a franchise as:

> "… 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 trade mark, 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 franchise fee."[56]

Under Section (a), New York will consider a business to be a franchise even in the absence of the FTC's foundational element of the use of the franchisor's marks. Thus, the cautious franchisor must insure that it meets the threshold requirements of each such state.

Even if one of the three pillars of the definition is missing, in the United States, the FTC and some 26 states will still regulate what are called "business opportunities". This is more fully discussed below.

54 16 Code of Federal Regulations, Section 436.1(h) (2007).

55 Federal Regulations, Volume 72, Number 61, p. 15459, third column. See http://edocket.access.gpo.gov/2007/pdf/E7-5829.pdf.

56 New York General Business Law, Article 3, Section 681(3) (2006). This Section of the law does provide for some exemptions from the application of this statute, but they are not relevant here.

The first Section of the FDD is the disclosure portion. In this part, the franchisor is required to respond to specific questions that are collected under 23 "Items",[57] each with a mandated title. The format of the document is highly formalized and requires:

- An FTC-required cover page with specific language and disclosures;[58]
- A NAASA-required "State Cover Page", which again contains specific information including "risk factors";[59]
- A table of contents;[60] and
- The Items.

Items by Title

In General

The following is a list of the Items (by correct title) and a brief discussion of the content required of each.[61]

Item 1 Franchisor and Any Parents, Predecessors and Affiliates

This Item requires the disclosure of such matters as the names and contact information for the franchisor and each of its affiliates. Any parent business entity and each predecessor to the franchisor also must be identified.

In addition, other matters must be disclosed in this Item, such as: the prior experience of the franchisor; a description of the business being offered; the market for the services of goods being offered; the competition that the franchisee may face; and, specific regulations or laws that affect the operation of the business.

Item 2 Business Experience

Here the franchisor must disclose the identity of all of the franchisor's officers, directors, general partners, trustees, and any other individual who will have management responsibility relating to the sale of, or the operation of, the franchise opportunity. For each such person, the franchisor also must provide the work history for the prior five years.

57 16 Code of Federal Regulations, Section 436.3 (2007).
58 16 Code of Federal Regulations, Section 436.3 (2007).
59 See http://www.nasaa.org/content/Files/2008UFOC.pdf at Section III(B).
60 16 Code of Federal Regulations, Section 436.4 (2007).
61 For a complete disclosure of the information required for each Item, see 16 Code of Federal Regulations, Section 436.5 (2007); Federal Regulations, Volume 72, Number 61, at p. 15473, third column. See http://edocket.access.gpo.gov/2007/pdf/E7-5829.pdf; http://business.ftc.gov/legal-resources/franchise-rule-compliance-guide at pp 26 et seq.; and http://www.nasaa.org/content/Files/2008UFOC.pdf, at pp 31 *et seq*.

Item 3 Litigation

This Item receives great scrutiny by the potential franchisees during the review process. The franchisor must disclose any litigation involving the franchisor, and/or its predecessor, parent,[62] or affiliate,[63] if such litigation alleges allegations concerning the franchise sales process, the franchisor's performance under the franchise documents, the sale of securities, claims of antitrust, fraud, unfair or deceptive trade practices, or comparable allegations.

The Revised Rule now requires the franchisor to disclose any franchisor-initiated litigation against its franchisees. Also new is the requirement that the franchisor disclose what would otherwise be usual business litigation if, in the aggregate, the sum of all judgments would materially negatively impact the franchisor's financial condition or its ability to operate the system as a whole.[64]

Item 4 Bankruptcy

The franchisor must disclose the bankruptcy history of the franchisor, parent, affiliates, and those people listed in Item 2 for the prior 10 years.

Item 5 Initial Fees

Here, the franchisor (and any of its affiliates) must disclose all of the initial fees that it charges to the franchisee before opening. Such fees include the initial fee paid to purchase the franchise rights (often called the "initial franchise fee"), computer or point-of-sale equipment that must be purchased only from franchisor or its affiliates, and similar fees.

Item 6 Other Fees

The franchisor must disclose in tabular form all of the fees, costs, and expenses that the franchisee can expect to incur during the life of the franchise which are paid to the franchisor or are collected by the franchisor for the benefit of a third party. Such line items will include royalties, advertising fees, insurance costs, renovation costs, and similar expenses.

Item 7 Estimated Initial Investment

Once again, using a table format, the franchisor must disclose a range of the minimum and maximum of all fees, costs, and expenses that the franchisee will incur prior to opening the business. This table will reflect the initial franchise

62 The parent's litigation is relevant only to the extent that the parent either guarantees the franchisor's performance or it otherwise provides financial support to the franchisor.
63 This requirement covers affiliates only to the extent that it offers franchises using the franchisor's marks or if the affiliate guarantees the franchisor's performance.
64 16 Code of Federal Regulations, Section 436.5(c)(1)(i)(B) (2007); 72 Federal Regulations, Number 61, p. 15477, first column. See http://edocket.access.gpo.gov/2007/pdf/E7-5829.pdf.

fee, real property expenses such as rent and construction costs, the cost for computer equipment, and similar line items.

Item 8 Restrictions on Sources of Products and Services

As the title implies, the franchisor must disclose any restrictions that it places on the right of the franchisee to purchase the goods and services necessary to open and then operate the business. For instance, it is typical for a franchisor to restrict the right of the franchisee to purchase electronic equipment, food products, and similar goods and service necessary in the operation of the business from any source other than one approved by it. Item 8 also will identify the franchisor's specifications for permitting a new vendor into the system, and will identify any revenue that the franchisor receives from the required purchases including rebates received by the franchisor from any supplier.

Item 9 Franchisee's Obligations

This required table indexes 25 line items as a cross reference guide to covenants in the franchise agreement.

Item 10 Financing

If the franchisor offers any financing to the franchisee, it must disclose the specifics of the financing in this Item, again in table format.

Item 11 Franchisor's Assistance, Advertising, Computer Systems, and Training

This is one of the more lengthy and important disclosure Items. Here, the franchisor must disclose the services that it will provide to the franchisee before and after opening.

Additionally, the disclosures in this Item will identify and describe all advertising expenditures and the type of computer and similar electronics necessary to operate the business. This Item also will provide a detailed description of the training that the franchisee can expect to receive. As part of this discussion, the franchisor will be required to disclose the table of contents of its operations manuals. It also will provide insight into the franchisor's site location requirements.

Item 12 Territory

The franchisor must disclose whether it offers the franchisee an "exclusive territory"[65] within which to operate the business. If none is offered, the

65 See https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs at question 25: "Item 12 requires that a franchisor that does not provide an exclusive territory include a disclaimer underscoring that fact. What constitutes an "exclusive territory" that would permit a franchisor to omit this disclaimer?" The response in brief says: In accordance with its well-established usage in franchising, Commission staff construe the term "exclusive territory" to mean a geographic area granted to a franchisee

franchisor must include an FTC-mandated disclaimer paragraph to that effect.[66] Other disclosure matters required by this Item include the franchisee's obligations upon relocation of the franchised business, the franchisee's right to purchase additional licenses, and the description of any sales quotas. The Information in this Item also will disclose the franchisor's reservation to itself of certain marketing and sales rights either within or outside any protected territory.

Item 13 Trade Marks

The disclosure of the types of trade marks, logos, or similar commercial marks that the franchisor owns, and the status of any filings relevant to the same, are identified in this Item. The franchisor also must disclose any limitations of the franchisee's right to use such marks.

Item 14 Patents, Copyrights, and Proprietary Information

If a patented good or process or a copyrighted item is a material component of the franchised business, the particulars, including the identity of the patent or copyright owner, any contract or agreement concerning the franchisee's use of the same, and other information material to the franchisee's understanding of how it will interface with the patent or copyright must be disclosed.

Item 15 Obligation to Participate in Actual Operation of Franchise Business

In this Item, the franchisor is asked to disclose whether and, if so, to what extent the franchisee must dedicate its time to the day-to-day operation of the business. It is common for the franchisor to make day-to-day participation a requirement.

Item 16 Restrictions on What Franchisee May Sell

The franchisor must disclose what restrictions, if any, it places on the franchisee's right to sell goods or services through the franchised business other than those offered as part of the franchise.

Item 17 Renewal, Termination, Transfer, and Dispute Resolution

Item 17 contains a cross-referencing table to the franchise agreement for 23 separate line items. It is different than Item 9 in that it includes a concise statement of the content of the particular franchise-agreement covenant as well as the location of the covenant in the agreement.

within which the franchisor promises not to establish either a company-owned or franchised outlet selling the same or similar goods or services under the same or similar trademarks or service marks".

66 See 16 Code of Federal Regulations 436/5(l)(5)(i) (2007).

Item 18 Public Figures

If the franchisor uses a public figure as part of its advertising scheme or otherwise as part of its promotion of the business, it must disclose the person's identity and any compensation paid to the person.

Item 19 Financial Performance Representations

A "Financial Performance Representation" means: "[A]ny representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that state, express or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits".[67]

To the extent that the franchisor wishes to do so,[68] it may disclose any financial data relevant to the actual operation of one or more company-owned or franchised businesses. It also may provide projections for future financial performance. If no FPR is offered, the franchisor is required to make a specified written disclosure.[69]

Item 20 Outlets and Franchisee Information

The franchisor must disclose in five separate tables and for the most recent three fiscal years, information about company-owned and franchisee-owned units. The information will include: a summary of company-owned and franchisee-owned units; the identity by state of businesses that have opened, or have closed by termination or expiration of the franchise agreement; businesses that were transferred; and the like.

To the extent that the franchisor has signed any confidentiality agreement with any present or past franchisees, the same also must be disclosed. As part of this Item, the franchisor also must provide (usually in an exhibit), with some limitations, the name and contact information of all present and past franchisees.

Item 21 Financial Statements

The franchisor will be required to disclose audited financial statements. New franchisors in non-registration states may phase-in the audits over a three-year

67 16 Code of Federal Regulations, Section 436.1(e) (2007).

68 Based on industry standards, only approximately 30 per cent to 40 per cent of all the franchise systems disclose Financial Performance Representations.

69 The key to any FPR is to insure that it is truthful and not misleading and that is the exact problem with this Item. What one person considers a fair and truthful disclosure, another will see as being inadequate and therefore misleading. Consider just one case in a long history of cases that allege that a misleading FPR was made: *Moxie Venture L.L.C., et al., v. The UPS Store, Inc.,* Business Franchise Guide (CCH) para 15,705 (D.C. MN 2016).

period.[70] Many of the registration states, however, require audited financials to be inserted for the first and then all subsequent FDD filings.

Item 22 Contracts

The franchisor must identify the title of, and must attach as exhibits to, the FDD all documents that the franchisee will be required to sign. Most often, all such contracts are part of the franchise agreement itself.

Item 23 Receipt

The last few pages of each FDD will include the "Receipt."[71] This document contains FTC-mandated information for the non-registration states. For many registration states, the Receipt will contain information that the state deems to be relevant. The purpose of the Receipt, which is to be signed, dated, and returned to the franchisor, is to memorialize the date that the prospective franchisee received the FDD. This date then marks the "quiet" period[72] during which the franchisee may review the entire FDD without having to sign the franchise agreement or pay any money to the franchisor.

Under the Revised Rule, the quiet period is 14 calendar days to be counted starting on the date following the date that the Receipt was signed and dated.[73] Notwithstanding this, several registration states still maintain a shorter or different quiet period, which must be followed if the same provides greater time to the prospective franchisee.[74] The Receipt also will recite the legal consequences of

70 For new franchise systems outside of registration states, the franchisor may phase-in such audits over a three-year period. 16 Code of Federal Regulations, Section 436.5(u) (2007). Many registration states required either heightened unaudited financial statements (California requires "reviewed" financials) or, like Hawaii, full-blown audits.

71 16 Code of Federal Regulations, Section 436.5(w) (2007) and NASAA Franchise Registration and Disclosure Guidelines. See http://www.nasaa.org/content/Files/2008UFOC.pdf.

72 The so-called quiet period does not preclude the franchisor and franchisee from talking about the franchise opportunity. Instead, it provides time — 14 calendar days from receipt of the FDD — during which he or she can consider the content of the document without being pressured to sign a document or pay any money. In truth, in most cases, the prospective franchisee may take months to consider whether to enter into the franchisor-franchisee relationship.

73 16 Code of Federal Regulations, Section 436.2(a) (2007).

74 New York and Rhode Island require that the franchisor gives the franchisee the disclosure document at the earlier of the first personal meeting or 10 business days before the execution of the franchise or other agreement or the payment of any consideration that relates to the franchise relationship. NY Gen. Bus Law, Article 33, Section 683; RI Gen Laws, Title 19, Chapter 28.1, Section 19-28.1-8. Michigan and Washington require that the franchisor gives the franchisee the disclosure document at least 10 business days before the execution of any binding franchise or other agreement or the payment of any consideration, whichever occurs first. Michigan Compiled Laws, Chapter 445, Section 445.1508; Washington Revenue Code, Title 19, Section 19.100.080.

failing to timely deliver the FDD and will contain the name of the person that acted as the franchisee's "franchise seller".[75]

Other Factors

The Registration states do have additional disclosure requirements. Although too voluminous to list here, the states (and the FTC[76]) prohibit the franchisee from signing a general release that would waive the franchisee's rights under the state-specific franchise statute[77] or the franchisee's right to rely upon representations made in the FDD. Furthermore, the states often attempt to void any covenant that would require the franchisee to litigate outside of the franchisee's home state or that would require the franchisee to become subject to the laws of a state other than its home state.[78] Many of the states also offer certain protection in the event of a termination or non-renewal.[79] The Revised Rule and the NASAA guidelines permit the franchisor to place certain required information into one or more exhibits. One will most often find as exhibits:

- A list of all state administrators and agencies who are authorized to receive service of process on behalf of the franchisor (this list includes registration and non-registration state agencies);
- The Franchise Agreement and all of its attachments;
- A table of contents of the operations manuals, which will include page numbers;
- The financial statements of the franchisor;
- A list and contact information of current franchisees;[80]
- A list and contact information of every franchisee who was terminated, did not renew, or who voluntarily or involuntarily ceased to do business within the most current fiscal year;[81]
- Any state-specific addenda;[82]

75 This is a new term-of-art under the Revised Rule. 16 Code of Federal Regulations, Section 436.1(j) (2007).

76 Under the Revised Rule, the franchisor is specifically prohibited from requiring the franchisee to disclaim or waive reliance on the representations made in the FDD. 16 Code of Federal Regulations, Section 436.9(h) (2007).

77 Illinois Franchise Disclosure Act, 815 ILCS, Sections 705 *et seq*.; Indiana Deceptive Franchise Practices Law, Indiana Code, Section 23-2-2.7-1(5); Minnesota Franchise Law, Minnesota Rule 2860.4400D.

78 Minnesota Franchise Law, Minnesota Stat., Section 80C.21; Minnesota Rule 2860.4400J; North Dakota Franchise Investment Law, Sections 51-19-01 *et seq*.; Washington Franchise Investment Protection Act, Chapter 19.100 RCW.

79 California Business and Professions Code, Sections 20000–20043; Hawaii Franchise Investment Law, Hawaii Revised Statutes, Title 26, Chapters 482E *et seq*.; Illinois Franchise Disclosure Act, 815 ILCS, Sections 705/19 and 705/20.

80 16 Code of Federal Regulations, Section 436.5(t)(4) (2007).

81 16 Code of Federal Regulations, Section 436.5(t)(5) (2007).

82 See http://www.nasaa.org/content/Files/2008UFOC.pdf at Section IV(A)(4).

- A list of each trade mark-specific franchisee organization associated with the franchise system,[83] and
- The Receipt.

The content of the FDD must be expressed in "plain English". "Plain English" means the organization of information and language usage understandable by a person unfamiliar with the franchise business including the use of: short sentences; definite, concrete, everyday language; active voice; and tabular presentation of information where possible. Plain English will avoid legal jargon, highly technical business terms, and multiple negatives.[84] If the document is reduced to printing, it must be 8.5 x 11 inches in size.[85]

The FDD can only contain the information required by the FTC, NASAA, or the state in which the FDD is to be delivered.[86] No extraneous or added information will be permitted. The signed Receipt[87] and entire FDD (including the franchise agreement) must be retained by the franchisor for a period of three years after the close of the fiscal year in which it was last used.[88]

Physical delivery of the FDD to the prospective franchisee may be done through the mail, by telefax, email, CD-ROM, website access, or in any other format.[89] If accessible only on the web, or if any other electronic format is password protected, the franchisor must provide the recipient with directions for accessing the document.[90] Regardless of the format in which it is delivered, the document must:

- Be delivered as a single integrated document or file;
- Contain no extraneous documents, content, web pages, or hyperlinks to other websites (although hyperlinks can be used in the body of the FDD to direct the reader from one paragraph to the another); and
- Be delivered in a format that is capable of being stored, retrieved, and printed.[91]

The FTC requires the FDD to be updated on a quarterly basis. Although such changes are not reviewed by any governmental organization in the non-registration states, the franchisor is expected to police its own documents and update the document when there is any "material change" to its content.[92] The phrase

83 16 Code of Federal Regulations 436.5(t)(8) (2007).
84 16 Code of Federal Regulations 436.1(n) (2007).
85 See http://www.nasaa.org/content/Files/2008UFOC.pdf at Section IV(A)(12).
86 16 Code of Federal Regulations 436.6(d) (2007).
87 16 Code of Federal Regulations 436.6(i) (2007).
88 16 Code of Federal Regulations 436.6(h) (2007).
89 16 Code of Federal Regulations 436.2(c) (2007).
90 16 Code of Federal Regulations 436.2(c) (2007).
91 NASAA Guidelines at http://www.nasaa.org/content/Files/2008UFOC.pdf, at p. 27.
92 16 Code of Federal Regulations 436.7(b) (2007).

"material change" is a legal term of art. Under the Federal Trade Commission Act[93] (which applies to the Revised Rule), the Commission identifies a matter as "material" if it is: ". . . likely to affect consumers' conduct or decisions with respect to the product at issue".[94] The Commission has clarified further that "… it is amply clear that 'materiality' is determined by the reasonable. . . prospective franchisee standard".[95]

The "reasonable person" (or, in this case, the "reasonable franchisee") legal standard has hundreds of years of Common Law support.[96] In franchising, the standard has been cited to determine: the existence of sufficient consent to form a contract;[97] whether a statute of limitation has run;[98] and whether a franchisor exercised sufficient care under the implied covenant of good faith and fair dealing inherent in the franchise agreement.[99]

The changes when made take immediate effect and become the standards by which the franchisor will operate from the date of the amendment forward. Included in such amendments should be quarterly unaudited financial statements. Quarterly updates to registration state franchise documents also are required. If such changes are material, the updates must first be approved by the state before the changes can take effect.

In both non-registration and registration states, any disclosure documents that are in the hands of prospective franchisees must be updated with the revisions and, if the updates are material, in most cases, the applicable quiet period must again be observed.

Both the FTC and the registration states have recognized certain situations in which a business may be exempt from application of the Revised Rule or the state regulations even though the relationship may technically be deemed to be a franchise.

93 15 United States Code, Section 41-58; see http://www.fda.gov/RegulatoryInformation/Legislation/ucm148712.htm.

94 72 Federal Regulations, Number 61, p. 15445, third column, citing with approval the Commission's comments in *Cliffdale Associate*, 103 FTC 110 (1984). See http://edocket.access.gpo.gov/2007/pdf/E7-5829.pdf.

95 72 Federal Regulations, Number 61, p. 15445, third column, citing with approval the Commission's comments in *Cliffdale Associate*, 103 FTC 110 (1984). See http://edocket.access.gpo.gov/2007/pdf/E7-5829.pdf.

96 *Black's Law Dictionary*, 9th ed, p. 1294, defines "reasonable person" as "[A] person who exercises the degree of attention, knowledge, intelligence, and judgment that society requires of its members for the protection of their own and others' interest."

97 *Dominik Unterberger et al., v. Red Bull North America, Inc.*, *Business Franchise Guide*, Paragraph 13,868 (California Ct. App. 2nd. Dist. 2008).

98 *Thompson et al,. v. Jiffy Lube International, et al.*, *Business Franchise Guide*, Paragraph 13,597 (D. Kan 2007).

99 *Wilcox et al., v Pirtek USA, LLC et al.*, *Business Franchise Guide*, Paragraph 13,404 (A.A.A., GA 2006).

The adoption of the Revised Rule permitted the FTC to revisit its exemptions.[100] The first exclusion is the so-called "minimum payment" exemption. The Revised Rule ratified the previously accepted US $500 minimum payment requirement.

That is, an offering will only be deemed to be covered by the Revised Rule if the prospect is required to pay US $500 or more at any time beginning before operations commence and ending "within six months of commencing operation of the franchisee's business. . . ".[101] It is reasoned that an investment of US $499 or less would be low enough to protect the buyer from financial ruin.[102]

The "fractional franchise" relationship[103] exemption also has reappeared in the Revised Rule. A fractional franchise is found when the purchaser has at least two years of experience in the "same type of business" that is being sold to him and when there is a good-faith reasonable basis to believe that the gross revenue generated through the franchise would be 20 per cent or less of the total revenue generated by the purchaser.[104]

"The 'same line of business' means selling competitive goods, or being in a business that would ordinarily be expected to sell the type of goods to be distributed [through the franchise]. . . ."[105] As an example, the franchisor of a franchised hot dog business would be exempt from disclosure if it were to sell the business opportunity to the owner of a pizza-type restaurant so long as the 20 per cent-of-gross-revenues limitation was met. On the other hand, this exemption may not be available if the seller was to offer the hot dog business to the owner of the coffee shop who wished to expand his offerings, since the owner would have to be taught how to handle, cook, and deliver the food.

The "leased department" exemption[106] also survived the revisions. The "leased department" is a relationship between a retailer (who would be the franchisor) and an unrelated business where the retailer permits the unrelated business to operate from the retailer's location and the unrelated business purchases no goods or services directly or indirectly from the retailer.[107] One example is the relationship between a large retail department store and the seller of a line of jewelry that leases a counter within the store.

While technically the unrelated business is paying rent (far in excess of US $500), and by being within the retailer's store is therefore associated with the

100 16 Code of Federal Regulations, Section 436.8 (2007).

101 16 Code of Federal Regulations 436.8(a)(1) (2007).

102 72 Federal Regulations, Number 61, at p. 15520, third column. Many registration states, however, have lower limits which in turn would trigger disclosure even if the US $500 limit is not reached. See California Corporations Code, Section 31011, and Md. Code Ann., Sections 14-201 and 14-214, where any fee that is paid could be considered a franchise fee. See http://edocket.access.gpo.gov/2007/pdf/E7-5829.pdf.

103 16 Code of Federal Regulations 436.8(a)(2) (2007).

104 16 Code of Federal Regulations 436.1(g) (2007).

105 See http://business.ftc.gov/legal-resources/franchise-rule-compliance-guide, p. 8.

106 16 Code of Federal Regulations 436.8(a)(3) (2007).

107 16 Code of Federal Regulations 436.1(n) (2007).

retailer's marks, and, arguably, the retailer exercises significant control over the seller (e.g., store hours and dress codes), the relative sophistication of the parties provides sufficient protection for both sides.

At 16 Code of Federal Regulations 436.8(a)(4), the FTC has renewed the exemption that is given to those who are covered by the Petroleum Marketing Practices Act (PMPA).[108]

New, however, to the list of exemptions in the Revised Rule is the "large franchisee investment" exemption.[109] Here, there are two opportunities for the purchaser to qualify.

If the prospective purchaser's initial investment is US $1-million[110] or more (excluding financing received from the franchisor and excluding the cost to purchase unimproved land), it is presumed that the prospect is sufficiently sophisticated to be able to protect his own interest without the need for disclosure. To avail itself of this exemption, the franchisor is required to have the franchisee sign an acknowledgement that specifically states:

> "The franchise sale is for more than US $1-million - excluding the cost of unimproved land and any financing received from the franchisor or any affiliate - and thus is exempted from the Federal Trade Commission's Franchise Rule disclosure requirements, pursuant to 16 Code of Federal Regulations 436.8(a)(5)(i)."[111]

Another exemption is available if the purchaser (or its parent or any affiliate) is an entity that has been in business for at least five years and has a net worth of at least US $5-million. This exemption exists regardless of the sophistication of the purchaser, or the nature of the business experience.[112]

The Revised Rule also added an exemption where the sale of the franchise is between the franchisor and any of its: ". . . officers, owners, and managers."[113] Again, this provides two opportunities for exemption:

- The prospect is, or within 60 days of the sale was, an officer, director, general partner, individual with management responsibility for the offer or sale of a franchise, or the administrator of the franchise system and he held the position for at least two years; or

108 15 United States Code 2801 (2007). The PMPA is a broad statute that covers the relationship between petroleum producers and, typically, gasoline stations.

109 16 Code of Federal Regulations 436.8(a)(5) (2007).

110 The monetary threshold expressed in this and other money-based exemptions is subject to adjustment based upon certain United States inflation indices. See generally: http://www.natlawreview.com/article/ftc-announces-revised-monetary-exemptions-under-franchise-rule. This figure was increased as of June 2012 to US $1.084-million.

111 See http://business.ftc.gov/legal-resources/franchise-rule-compliance-guide, at p. 10.

112 The FTC Franchise Rule Compliance Guide provides additional insight into the scope of this exemption. See http://www.ftc.gov/bcp/edu/pubs/business/franchise/bus70.pdf, at p. 10.

113 16 Code of Federal Regulations 436.8(a)(6) (2007).

- The prospect is, or within 60 days of the sale was, an owner of at least 25 per cent of the total ownership in the franchisor.

The final exemption is one that practitioners are having a difficult time grasping. Where the agreement between a buyer and seller is strictly oral in nature and even if it contains all of the hallmarks of a franchise, it will be exempt.[114] The FTC's adoption of this exemption was its way of recognizing the difficulty of finding sufficient evidentiary proof for the enforcement of the oral agreement.

The problem here, however, is that states have different requirements in recognizing the enforceability of oral contracts. Traditionally, oral contracts are enforceable if there is sufficient certainty of the terms.[115] Many of the registration states recognize the existence and enforceability of such agreements.[116]

Although not deemed to be an "exemption" *per se*, the Revised Rule recognizes that the sale of a franchised business by an existing franchisee to a new franchisee will not trigger the need for the franchisor to redisclose[117] so long as the franchisor played no material part in the transaction. Merely vetting the transferee is not sufficient to trigger the disclosure requirement.[118] Registration states have not always adopted identical exemptions.[119]

In September of 2014, NASAA adopted its "Multi-Unit Commentary"[120] in which it defines the several multi-unit purchase options available to a prospective franchisee, area developer, or subfranchisor.

NASAA defines an "Area Development" agreement as one between the franchisor and a franchisee (Area Developer) who agrees to develop an agreed-upon number of unit franchises, within an agreed-upon period of time (sometimes called the "Development Period"), and within an agreed-upon geographic territory (sometimes called the "Development Area").[121] Due to the length of the Development Period, the Area Developer may be required to sign

114 16 Code of Federal Regulations 436.8(a)(7) (2007).

115 Restatement, Second, Contracts, Sections 1 and 110. Oral contracts are subject to each state's statute of fraud, which requires that a contract for a certain term be in writing.

116 In *Dennis Hoard v. Texaco Refining*, *Business Franchise Guide*, Paragraph 11,771, Case Number 99-2092-KHV (DC Kan. 1999), a Kansas court found that an oral promise was sufficient to create a franchise relationship under the Kansas Petroleum Marketing Practices Act.

117 16 Code of Federal Regulations 436.1(t) (2007), which defines a "sale of a franchise" for which disclosure must be made.

118 16 Code of Federal Regulations 436.1(t)(2007).

119 Table 2 lists such exemptions.

120 See "http://www.nasaa.org/wp-content/uploads/2011/08/Franchise-Multi-Unit-Commentary-effective-Adopted-Sept.-16-2014.pdf." and then go to the "Multi-Unit Commentary Introduction" tab in the search results.

121 See "http://www.nasaa.org/wp-content/uploads/2011/08/Franchise-Multi-Unit-Commentary-effective-Adopted-Sept.-16-2014.pdf." and then go to the "Multi-Unit Commentary Introduction" tab in the search results.

franchise agreements that are different than the one that was disclosed in the original FDD.

NASAA defines "Subfranchise Rights" as the rights granted by the franchisor to a third party (Subfranchisor) who will itself sell unit franchises to franchisees (Subfranchisee) within a geographic area. In this case: (i) the Subfranchisor is required to deliver to the prospective Subfranchisee a FDD for both the franchisor and subfranchisor; (ii) the Subfranchisor and not the franchisor signs the franchise agreement; and (iii) the Subfranchisor and not the franchisor delivers all of the required services to the franchisee and otherwise administers the entire franchise relationship. The franchisor and Subfranchisor usually split the initial franchise fee, royalties, and other fees generated through the franchise relationship.[122]

NASAA defines an "Area Representation" arrangement as one in which the franchisor grants to a third party (Area Representative) the right to "…solicit or recruit third parties to enter into unit franchise agreements with the franchisor, and/or to provide support services to third parties entering into unit franchise agreements with the franchisor".

In this case, it is usual for the Area Representative to refer to franchisor "qualified" franchise prospects who, if approved, will sign the franchise agreement with the franchisor. Area Representatives cannot sign the franchise agreement without being considered a Subfranchisor. The Area Representative typically delivers to the unit franchisee pre-opening and post-opening services that otherwise would be delivered by the franchisor. In most cases as well, the Area Representative will replace the franchisor as the point-person who fields questions and complaints from franchisees within the Area Representative's development area.[123]

The Commentary then identifies the Items within the FDD that must be supplemented as a result of each relationship. For instance, under the Area Development commentary, the franchisor is required to disclose in Item 1 whether the Area Developer is required to sign the then-current franchise agreement as opposed to signing a franchise agreement that is identical to the one that was disclosed in the original FDD.[124]

Business Opportunity Regulation

As noted above, the mere absence of one of the elements of the franchise definition in a non-registration state and in some other states does not free the seller from regulation. Under the auspices of the Federal Trade Commission Act, the FTC also regulates what are called "business opportunities". In fact, until the Revised Rule was enacted, both franchises and business opportunities were regulated by the same statute. In 2011 (effective in 2012), the FTC

122 S*upra.* note 120.
123 S*upra.* note 120.
124 *Supra.* note 120.

finalized the revision to the business opportunity regulation which was split out and can now be found at 16 Code of Federal Regulations 437[125] (the "Business Opportunity Rule").[126]

The Business Opportunity Rule is fashioned after the Revised Rule and includes the drafting and delivery of a disclosure document. Although business opportunities are typically less costly than a franchise and most often are subject to a very short and simple contract between the seller and the buyer, the FTC has recognized the great opportunity for abuse (business opportunity scams cost Americans millions of dollars every year)[127] and, thus, the need for regulation.

Examples of business opportunities include so-called "rack distributorships" where the purchaser obtains the right to stock retail display racks with the seller's products (e.g., magazines and simple car tools) and vending machine businesses where the seller sells the buyer vending machines for placement in retail locations. In reality, any business structure that meets the definition of a business opportunity will come under the statute's purview. Under the Business Opportunity Rule, a "business opportunity":

> "c) . . . means a commercial arrangement in which:
>
> " (1) A seller solicits a prospective purchaser to enter into a new business; and
>
> "(2) The prospective purchaser makes a required payment; and
>
> "(3) The seller, expressly or by implication, orally or in writing, represents that the seller or one or more designated persons will:
>
> "(i) Provide locations for the use or operation of equipment, displays, vending machines, or similar devices, owned, leased, controlled, or paid for by the purchaser; or
>
> "(ii) Provide outlets, accounts, or customers, including, but not limited to, Internet outlets, accounts, or customers, for the purchaser's goods or services; or
>
> "(iii) Buy back any or all of the goods or services that the purchaser makes, produces, fabricates, grows, breeds, modifies, or provides, including but not limited to providing payment for such services as, for example, stuffing envelopes from the purchaser's home."[128]

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125 See http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=34374237e89b98184d0c7ad1f0ac5669&rgn=div5&view=text&node=16:1.0.1.4.54&idno=16.

126 The Business Opportunity Rule was finalized in 2012 and became effective on 1 March 2012. See http://www.ftc.gov/os/fedreg/2011/11/111122bizoppfrn.pdf and http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&tpl=/ecfrbrowse/Title16/16cfr437_main_02.tpl.

127 See http://www.ftc.gov/opa/1995/07/scam.shtm.

128 16 Code of Federal Regulations 437.1(c) (2012).

A business offering that meets the federal definition requires the seller to deliver the statutorily defined business opportunity disclosure document (BODD). The revised 2012 format changes what used to be the requirement to deliver an eight- to 15-page document that closely mirrored the old UFOC, to one that is now one to two pages long.[129]

As in franchising, 26 states have passed business opportunity laws that augment the Business Opportunity Rule.[130] In keeping with the Revised Rule, the FTC Business Opportunity Rule will only be preempted by a portion of a state statute that provides the prospective buyer with greater protection.[131]

Thus, the careful drafter of a BODD must again conform not only to the federal requirements, but also to those of each of the states that has a business opportunity law. There are, however, exemptions from the Business Opportunity Rule. As specifically covered by this rule:

> "The provisions of this [Business Opportunity] Rule shall not apply to any business opportunity that constitutes a 'franchise,' as defined in the Franchise Rule, 16 CFR part 436; *provided, however,* that the provisions of this Rule shall apply to any such franchise if it is exempted from the provisions of part 436 because, either:
>
> > "(a) Under §436.8(a)(1), the total of the required payments or commitments to make a required payment, to the franchisor or an affiliate that are made any time from before to within six months after commencing operation of the franchisee's business is less than $500, or
> >
> > "(b) Under §436.8(a)(7), there is no written document describing any material term or aspect of the relationship or arrangement."[132]

Timing for the delivery of the BODD is as important as it is for the FDD. The Business Opportunity Rule now requires that the seller deliver the BODD at least seven calendar days prior to the date that the buyer signs any contract in connection with the sale, or the date that a payment or the delivery of consideration is given to the seller.[133]

The federal business opportunity regulations also require a seller who conducts sales or the promotion of the business opportunity in Spanish or another language to deliver a BODD in the same language.[134]

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129 16 Code of Federal Regulations 437.3 (2012).
130 See Table 3.
131 16 Code of Federal Regulations 437.9 (2012).
132 72 Federal Regulations, Number 61.15569, second column. See http://edocket.access.gpo.gov/2007/pdf/E7-5829.pdf; 16 Code of Federal Regulations, Section 437.8 (2012).
133 16 Code of Federal Regulations 437.2 (2012).
134 16 Code of Federal Regulations 437.5 (2012).

Disputes Relating to Franchise Agreements

The state and federal courts of the United States have more than 30 years of experience in dealing with franchise disputes. Causes of action range from claims of "fraud in the inducement"[135] and simple breach of the franchise contract[136] to those involving complex issues of choice of law[137] and forum selection covenants.[138]

Also included in litigation are contests in which the plaintiff franchisee alleges that the franchisor has made either an inadvertent or intentional financial performance representation (Item 19 of the FDD) or its former iteration: the "earnings claim" (which was also identified in Item 19 of the old Rule).[139]

Guiding all litigation in the franchise and business opportunities arena is the understanding that the Trade Commission Act (the "Federal Trade Commission Act") does not permit private parties (i.e., franchisors, franchisees, or business opportunity sellers or buyers) a "private right of action"[140] to sue for alleged breach of the Revised Rule or the Business Opportunity Rule. Specifically, Section 5 of the Federal Trade Commission Act and legal precedent hold that only the FTC can bring an action for such violations.[141]

Thus, in the presence of a claim of breach of the Revised Rule or the Business Opportunity Rule, an injured party must instead complain in state or federal

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135 "Establishing fraud in the inducement requires establishing the elements of Common Law deceit [cite omitted]. . . ". *Rohm and Haas Electronic Materials, LLC v. Electronic Circuits Supplies, Inc.,* U.S. District Court, D. Massachusetts (22 December 2010), *Business Franchise Guide*, Paragraph 14,521.

136 *Hockey Enterprises, Inc. et al. v. Total Hockey Worldwide, LLC*, U.S. District Court, D. Minnesota (10 January 2011), *Business Franchise Guide*, Paragraph 14,531.

137 *Bapu Corp., et al. v. Choice Hotels International, Inc.*, U.S. District Court, D. New Jersey (23 December 2010), *Business Franchise Guide*, Paragraph 14,519.

138 *Tilted Kilt Franchise Operating LLC, v. Jeremy Helper; Bakersfield Kilt, Inc.,* U.S. District Court, D. Arizona (9 December 2010), *Business Franchise Guide*, Paragraph 14,497.

139 16 Code of Federal Regulations 436.1(e)(1979); 16 Code of Federal Regulations, Section 436.5(s)(1979); 72 Federal Regulations, Number 61, Section.15497, first column, through Section 15501, first column. See http://edocket.access.gpo.gov /2007/pdf/E7-5829.pdf. 16 Code of Federal Regulations, Section 437.2(a)(3) (2007). There are numerous cases involving such matters. *Hockey Enterprises, Inc. et al. v. Total Hockey Worldwide, LLC*, *Business Franchise Guide*, Paragraph 14,531 (D. Minnesota, 2011); *Colorado Coffee Bean et al. v. Peaberry Coffee, Inc.*, *Business Franchise Guide* (Ct. App. Colo. 2010), Paragraph 14,325.

140 A private right of action gives the individual the right to directly enforce a state or federal statute or claim. *Black's Law Dictionary* (9th ed, 2009) p. 1437 ("private right"). *Explanations, Laws, cases, rulings, new developments*: *Private right of action-Federal Trade Commission Act, Business Franchise Guide*, Paragraph 1412.78 (2011).

141 15 United States Code, Section 45 (2010); *Webb v. Primo's Inc.,* 706 F. Supp. 863 N.D. GA (1988).

courts through the use of existing common or statutory state law,[142] complain through a different federal law that recognizes a private right of action, or appeal to the FTC for help, in which event the FTC would be the plaintiff in the litigation.

In the registration states, the situation is different insofar as state statute or regulation will permit private rights of action for claims under the state's franchise statute. Many statutes reiterate the Revised Rule requirements (e.g., the content of the disclosure document and the timing for delivery of the same to a citizen of that state), so that an aggrieved party that can find jurisdiction in such a state can then enforce the spirit, if not the exact letter, of the Revised Rule or the Business Opportunity Rule.

Substantive Legal Issues

Antitrust Laws

Generally, franchising, like all other industries in the United States, is subject to governmental anti-competition control. The foremost of such regulations is found in the Sherman Antitrust Act, which was promulgated in 1890.[143] The Sherman Antitrust Act, at Chapter 1, sets the tone of the regulation and states:

> "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding US $100,000,000 if a corporation, or, if any other person, US $1,000,000, or by imprisonment not exceeding 10 years, or by both said punishments, in the discretion of the court."[144]

The Sherman Antitrust Act was later supplemented by the Clayton Antitrust Act of 1914.[145] The FTC then came into play when Congress passed the Federal Trade Commission Act of 1914 in order to protect consumers from unfair

142 Most states have statutes generically identified as "Little Federal Trade Commission Acts" which permit the plaintiff to bring unfair trade practices claims, which may offer the party a back door for claiming at least that an act violated his right to be treated fairly, honestly, and openly. *Explanations, Laws, cases, rulings, new developments, Little Federal Trade Commission Acts—Overview*, *Business Franchise Guide*, Paragraph 1700 (2011); Conn. GSA, Sections 42-110 *et seq*.

143 Sherman Antitrust Act, 15 United States Code, Section 1 (2010). See http://www.law.cornell.edu/uscode/15/usc_sup_01_15_10_1.html.

144 Sherman Antitrust Act, 15 United States Code, Section 1 (2010).

145 Clayton Antitrust Act, 15 United States Code, Sections 12 *et seq*. (2010). See http://www.law.cornell.edu/uscode/15/usc_sup_01_15_10_1.html. The Clayton Antitrust Act serves to supplement the Sherman Antitrust Act and became law in 1914.

competition and deceptive trade practices.[146] The Clayton Antitrust Act was then amended by the passage of the Robinson-Patman Act,[147] which prevents so-called price discrimination or restraint on trade.[148] The United States Supreme Court explained the purpose of the Sherman Antitrust Act and the government's obligation to prevent restraints on competition in a very specific way:

> "The purpose of the Act is not to protect businesses from the working of the market; it is to protect the public from the failure of the market. The law directs itself not against conduct which is competitive, even severely so, but against conduct which unfairly tends to destroy competition itself. This focus of United States competition law, on protection of competition rather than competitors, is not necessarily the only possible focus or purpose of competition law. For example, it also has been said that competition law in the European Union (EU) tends to protect the competitors in the marketplace, even at the expense of market efficiencies and consumers."[149]

The Sherman Antitrust Act, the Clayton Antitrust Act, the Federal Trade Commission Act, and the Robinson-Patman Act, when taken together, seek to encourage competition. In the context of franchising, the acts most often come into play when discussing "vertical" or "horizontal" restraints on trade. A vertical restraint of trade occurs when two parties who are at different levels of distribution (e.g., a franchisor and franchisee) conspire to "fix" the price of the goods or services being sold.[150] A horizontal restraint of trade occurs where two or more competitors who are at the same level of distribution (e.g., wholesalers of nuts and bolts) conspire to fix the price of the goods or services being sold such that each will sell the good or product at an agreed-upon price.[151] Each allegation of violation of the acts and of the prohibition against horizontal and vertical restraint on trade will be determined by the application of one of two criteria:

- The *per se* violation of any one of the acts; or
- The "rule of reason" analysis.

Per se restraints are found upon proving the behavior occurred and that it fell within a *per se* category. *Per se* violations include price fixing, bid rigging, and

146 Federal Trade Commission Act; 15 United States Code, Section 45(a)(1). The FTC is charged with protecting the public from "[u]nfair methods of competition in or affecting commerce and unfair or deceptive trade acts or practices . . .".

147 Robinson-Patman Act, 15 United States Code, Section 13 (2010). See http://www.law.cornell.edu/ uscode/text/15/13.

148 *FTC v. Morton Salt,* 334 U.S. 37 (1948) (Supreme Court upheld the FTC's right to police price discrimination). See http://caselaw.lp.findlaw.com/scripts/getcase.pl ?court=US&vol=334&invol=37.

149 *Spectrum Sports, Inc., v. McQuillan*, 506 U.S. 447, at p. 458 (1993).

150 *Black's Law Dictionary* (9th ed., 2009), at p. 1429 (2009).

151 *Black's Law Dictionary* (9th ed., 2009), p. 1429 (2009).

territorial or customer allocations among competitors (often called "horizontal agreements").[152] There is no need to prove that the actual effect of the behavior will be an unreasonable restraint on trade or to prove that the party's intention was to restrain competition.[153] In franchising, such *per se* violations were in the past often found in "tying" arrangements. A tying arrangement is found where the seller conditions the purchase of one product on the purchase of a second product or conditions the purchase of a product on the buyer's agreement to refrain from buying the product from any other source.[154]

The "rule of reason" analysis requires the complainant to go further. He must demonstrate not only the existence of a statute that prohibits an action but also must prove that engaging in the act would cause either actual or potential harm to competition,[155] a more difficult burden.

In franchising, one often sees the specter of a restraint of trade in so-called "resale price maintenance" or "RPM" cases. There are two types of such restraints: ones that seek to control the minimum price at which a good or service can be sold, and ones that restrict the maximum price at which it could be sold. Beginning in 1911 with *Dr. Miles Medical Company v. John D. Park & Sons Co.* ,[156] the United States Supreme Court held that the attempt to enforce such restraints was a *per se* violation of the Sherman Act.

This holding that RPMs are *per se* violations has been applied where an international sport shoe seller conspired with large retailers to fix the minimum price at which the retailer would sell its shoes;[157] to a relationship between a supplier of abrasives and one of its distributors the effect of which was to deny another distributor the ability to buy at the same price;[158] and in a case where a

152 See http://topics.law.cornell.edu/wex/antitrust.

153 As the Supreme Court described in *Business Electronics Corp.* v. *Sharp Electronics Corp.*, 485 U. S. 717, 723 (1988), *per se* violations should be found only in a restraint ". . . that would always or almost always tend to restrict competition and decrease output".

154 *Eastman Kodak v. Image Technical Services, Inc.,* 504 U.S. 451 at 462 (1992). It is noteworthy that the United States Supreme Court has made it clear that *per se* violations should be found infrequently. *White Motor Co. v. United States,* 372 U.S. 253 at 263 (1963).

155 The rule of reason standard was originally identified in *Standard Oil Co. of Jersey V. United States,* 221 U.S. 1 (1911), where the court found that only combinations and contracts that unreasonably restrain trade would be subject to the Sherman (and the other) Acts. *Continental T.V., Inc. v. GTE Sylvania, Inc.,* 433 U.S. 36 (1977). *Benny Jacobs et al. v. Tempur-Pedic International, Inc.*, *Business Franchise Guide*, Paragraph 14,499 (11th Cir. 2010).

156 *Dr. Miles Medical Company v. John D. Park & Sons Co.,* 220 U.S. 373 (1911). *Ozark Hartland Electronics, Inc. v. Radio Shack*, *Business Franchise Guide*, Paragraph 12,256 (8th Cir. 2002).

157 *States' Attorneys General v. Reebok*, *Business Franchise Guide*, Paragraph 10,693 (S.D. New York 1995).

158 *DeLong Equipment Co. v. Washington Mills*, *Business Franchise Guide*, Paragraph 10,229 (11th Cir. 1993).

car manufacturer and some of its dealers conspired to fix prices in order to force a discount dealer out of business.[159]

On the other hand, a *per se* restraint will not be found where a franchisor fixes the prices at which its franchisees can sell some goods since the trade marks of the franchisor and the product being controlled may be so intertwined as to be deemed but one inseparable good. For instance, no restraint on trade was found where the franchisor forced its franchisee to lease the franchised location only from a franchisor since the quality of structure and its interior and exterior design were essential parts of a single formula for success.[160]

In 1997, in *State Oil vs. Khan*, [161]the Supreme Court went further in dismantling the *per se* violation concept when it struck down the use of a *per se* measurement in cases dealing with the fixing of maximum prices, using instead the rule of reason as the yardstick by which to measure such matters.

In 2007, the Supreme Court again took to task the *Dr. Miles* line of cases when it decided *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*[162] In *Leegin*, the Supreme Court was asked to determine whether the termination of a retailer's license because it set its prices below that manufacturer's suggested price (vertical price fixing) was a *per se* violation of the Sherman Act and *Dr. Miles*.

After a lengthy analysis, the court overruled the *Dr. Miles* line of precedent and found that, even though vertical price fixing ". . . is an ever present temptation… it cannot be stated with any degree of confidence that retail price maintenance..."[163] decreases competition. As a result, any claim relating to vertical price fixing, including minimum price fixes, must be measured by the rule of reason.

After the ruling in *State Oil* (finding that maximum price fixing must be measured as a rule of reason violation), the franchise community embraced the new-found opportunity. Especially in the fast food sector, industry giants such as McDonald's and Burger King imposed maximum price ceilings on such customer incentives as the "dollar" menu. A similar reaction was anticipated after *Leegin* struck down minimum price fixing as a *per se* violation.

Instead, the franchise community has been more wary about taking action in this area of minimum price fixing. Many believe that it is the dearth of case law and court guidance subsequent to *Leegin* along with the use of older franchise agreements that prevent the fixing of minimum prices that have resulted in relatively few systems adopting a minimum fixed-price program.[164]

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159 *In Re: The Bankruptcy Estate of John Perterson Motors, Inc., et al. vs. General Motors Corp., Business Franchise Guide*, Paragraph 10,081 (D. Minnesota 1992).

160 *Principe v. McDonald's et al.,* 631 F.2d 303 (4th Cir. 1980).

161 *State Oil v. Khan,* 522 U.S. 3 (1997).

162 *Leegin Creative Leather Products, Inc. v. PSKS, Inc.,* 551 U.S. 877 (2007).

163 *Leegin Creative Leather Products, Inc. v. PSKS, Inc.,* 551 U.S. 877, 878 (2007).

164 Vital and Wirmani, "Leegin: All Bark, Number Bite?", *Franchise Lawyer*, Volume 13, Number 3 (Summer 2010).

Import Controls and Duties

United States Custom and Boarder Protection (CBP),[165] a division of the Department of Homeland Security, is in charge of overseeing imports into the country. At each port of entry into the United States (regardless of the manner of transport), the sender must identify the goods and declare the value of the shipment.

Import duties are the tax an importer is required to pay to the United States Government before bringing products from abroad into the commerce of the United States. The rules for calculating import duties are very complex, but are usually calculated as a percentage of the declared value of the product. Import duties can range from 0 to 100 per cent of the product's declared value and will vary based on numerous factors, including the type of product, country of origin, anti-dumping legislation, and quota controls.[166]

The United States International Trade Commission[167] offers a complete guide to such tariffs in the Harmonized Tariff Schedule of the United States. There are 99 Chapters of regulations that cover everything from the importation of live animals (including hoofed animals and worms — found at Chapter 1) to the importation of works of art (Chapter 97). For instance, the importation of cotton (Chapter 52) in various forms is controlled first on a country-by-country quantity basis (e.g., Argentina may import 2,360 kilograms, and Brazil may import in excess of 280,000 kilograms), and then according to the kilogram weight that is imported.[168] In addition, one must consider the innumerable trade agreements between the United States and countries from around the world, which will impact both the tariffs and limit imports, depending on the trade agreement.[169]

Relevant Practice

Contract Term

The length of franchise agreements ranges from two to 20 or more years. There is no industry-wide standard. Instead, the franchisors in each industry sector tend to group around a range of years. Many full-service restaurant concepts have franchise agreements that grant franchisees an initial term of between 10 to 20 years, and grant one or even several renewal options for similar periods of time. On the other hand, franchises for work-at-home concepts, such as publication sales, may have terms of five to seven years with several renewals of equal length.

165 See http://www.cbp.gov/xp/cgov/about/.
166 See http://www.import-duty.com/ and http://hts.usitc.gov/.
167 See http://usitc.gov/press_room/about_usitc.htm#Overview.
168 See http://hts.usitc.gov/.
169 For a list of treaties and the limitations on imports under each treaty, see Harmonized Tariff Schedule of the United States, USITC Publication 4201, General Notes Section (2011). See http://hts.usitc.gov/.

Transfer of Know-How

The foundation of any franchise agreement is the limited non-exclusive license that grants the franchisee access to the franchisor's proprietary information. Such license is strictly limited in time, scope, and usage, and is never considered to be a sale of such knowledge so as to transfer title of the same to the franchisee. Once the franchise relationship is terminated, the license to use the know-how ceases and the franchisee is prohibited from using such knowledge to the detriment of the franchisor.

Royalties and Other Fees

Royalties represent an on-going stream of income for the franchisor. Typically, royalties are based upon a percentage of the gross revenue[170] that a franchisee takes in. Such percentages range from one per cent to 10 per cent or more. As with the term, royalties tend to be consistent within a given industry sector. It is typical for quick casual restaurants to charge a royalty of between four per cent and six per cent. Full service restaurants may charge more. It is unusual to see a royalty of greater than 10 per cent, as simple market forces would discourage prospects from purchasing the same.

In addition to royalties, it is typical for a franchisor to require the expenditure of a portion of gross revenue on advertising. Franchisors most often divide these costs into "local" and "national" advertising fees. National advertising funds are typically paid to the franchisor for use in nationally advertising the brand. This fee can run between one per cent and four per cent of the gross revenue. Funds for local advertising are typically expended directly by the franchisee in his territory, and can range between one per cent and four per cent.

The list of costs and fees to be expended by the franchisee to open the business and then to operate it during the life of the franchise must be listed in Items 7 and 6, respectively, of the FDD. Item 8 of the FDD lists those purchases that franchisee is required to make only from the franchisor or franchisor's approved vendors.

Although franchisors are required by regulation to disclose the fees and costs that franchisees will incur, there are virtually no restrictions on what the franchisor may require the franchisee to spend. Thus, the franchisor may, for example, collect a fee upon transfer of the franchise to another franchisee or at the time of renewal of the contract, or may require the franchisee to renovate the business from time to time, or may charge the franchisee a fee for access to the

170 The term "gross revenue" is defined by the franchisor and may vary from system to system. In most cases, gross revenue will mean all of the revenue generated by all of the services or products sold through the franchised business. It includes all cash and credit card transactions as well as bartered or traded services. In most cases, before gross revenue is calculated, taxes collected by the franchisee that are then paid to a governmental authority are first deducted, as are verifiable returns of products. Usually, credit card transactions that are later reversed or denied are not first deducted.

franchisor-hosted web-site or require the franchisee to purchase and then update electronic equipment used in the business.

Innovations

During the franchise relationship, the franchisee may discover or invent improvements to the franchisor's system (e.g., a more streamlined method of accounting), or a new recipe. Most franchise agreements contain a covenant that requires such innovations to be transferred to the franchisor under the theory that the same was found as a result of the franchisee's operation of the franchised business and would not have been discovered or invented but for such relationship. Such covenants will typically permit the franchisor to then use the innovation for the benefit of the entire system. The franchisee may or may not be compensated for the same.

Restrictions on Source Materials

A characteristic of most franchise systems is the requirement that the franchisee use only goods and services that have been approved by the franchisor (Items 8 and 16). This is the logical consequence of the desire to present the public with a consistent image of the business.

Although, in some cases, such limitations are identified as vertical restrictions on trade in franchising, such restraints are measured by the rule of reason and are, for the most case, seen as a necessary and essential part of the franchise business model. Thus, it is normal and usual for the franchisor to require the franchisee to purchase certain goods, products, or services only from the franchisor.

For instance, several of the giant, quick-service restaurant franchisors control each and every item that is used in the franchised business from the napkins and other paper products containing the franchisor's marks to the vendor of each food product.

In many cases, the franchisor owns the entire distribution system and realizes significant income and profit from such relationships. The FDD requires only that the franchisor disclose the same to the franchisee so he can make an informed business decision about the efficacy of the franchised business.

Exclusive Territories

The Revised Rule requires in Items 11 and 12 of the FDD that the franchisor identify the method by which the franchisee finds a location (Item 11), and what, if any, exclusive territory is awarded to the franchisee (Item 12).

Once again, the Revised Rule mandates disclosure, but does not necessarily require the franchisor to grant an exclusive territory. If the franchisor does grant an exclusive territory, it has several obligations, including that it must:

- Identify the manner and method by which an exclusive territory is determined;
- State the length of time during which the exclusivity remains in effect;

- Identify what, if any, exceptions are made that would permit competition within the franchisee's exclusive territory; and
- Identify the franchisee's right to relocate the business.

If the franchisee is not given an exclusive territory, the FDD must state: "You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that [franchisor] owns, or from 'other channels of distribution'[171] or competitive brands that we control."[172]

Even if an exclusive territory is granted, it is common for the franchisor to retain the right for itself to make sales in the franchisee's exclusive territory in other channels of distribution.

Thus, the franchisor will preserve for itself (or its affiliates) the right to exploit Internet, catalog, television, or similar sales venues to exclusion if the franchisee.

Sales Quotas

It is typical to see some form of sales quota in franchise agreements. The sales quotas may be based upon gross revenue, units sold, market penetration, or similar markers. Such quotas must be identified in Item 12 of the FDD and must address whether the continued territorial exclusivity (if any) depends on meeting the quota requirements.

Penalties for falling short of the stated goal vary, with some systems agreeing to provide additional training, assistance, or time to meet the goal, while other systems simply terminate the franchise agreement without a right to cure.

Official Language of the Agreement

The FTC requires all franchise-related documents to be expressed in "plain English". This is deemed to be a term-of-art and is defined elsewhere in this treatise.[173]

Covenants Not to Compete

A vast majority of franchise agreements in the United States contain restrictive covenants that seek to curb certain behavior of a franchisee. Such covenants include restrictions against the disclosure to others of proprietary, trade secret, trademarked, or similar sensitive information; the prohibition of "looting" the franchisor or other franchisees of key employees or personnel; and "in-term"

171 16 Code of Federal Regulations 436.5 (l)(5)(ii) (2007). Other channels of distribution are considered to be alternative methods of selling the franchisor's products. Thus, for a bricks-and-mortar restaurant that specializes in selling baked goods, an alternative channel of distribution would be the sale of baked goods by the franchisor to grocery stores in the franchisee's territory, or the sale of the goods over the Internet.

172 16 Code of Federal Regulations 436.5(l)(5)(i) (2007).

173 See 16 Code of Federal Regulations 436.1(o).

and "post-term" covenants not-to-compete with other franchisees or the franchisor. The latter restrictions garner the most attention and litigation.

A covenant not to compete is a term in that contract that seeks to prevent the promisee from competing against the promisor by restraining the promisee from what otherwise would be his lawful right to work. These covenants are found in a myriad of contracts from employment agreements to asset or capital-stock purchase agreements.

Covenants not to compete in a franchise setting can be divided into two categories: covenants not to compete which are enforceable during the term of the franchise agreement ("in-term covenant not to compete"), and covenants which seek to prevent competition after the franchise relationship ceases ("post-term covenant not to compete").

From the franchisor's point of view, both the in-term and post-term covenants are common sense limitations that allow the franchisor the freedom to expose its proprietary trade secrets to the franchisee without fear that he will simply use the knowledge to open up a competitor. The franchisee, on the other hand, often feels that he has paid for the education and should be permitted to use the knowledge as deemed appropriate. Technically, such covenants can be viewed as non-monetary vertical restraints on trade and thus would be regulated by the Sherman Act's jurisdiction. One court, however, has expressed what appears to be the sentiment of the federal bench. In *Capital Temporaries, Inc. v. Olsten Corporation*,[174] the court held that:

> "As we have pointed out recently in *Bradford v. New York Times Co*., 501 F.2d 51 (2d Cir. 1974), restrictive covenants [not to compete] have invariably been litigated in state courts or in diversity cases in federal courts applying state law. They do not rise to the status of Sherman Act violations; in fact, no court applying the rule of reason has ever held them to be violative of the Act. *Bradford* at 59. And they are certainly not of *per se* stature."

As a result of this viewpoint, virtually all litigation concerning such covenants is either state based, or is a federal court's interpretation of the state's statute. The 50 states, the District of Columbia, and the United States Virgin Islands each have a statute that addresses, in some form, the covenant not to compete. Consequently, the courts of each state have interpreted such state's statutes in accordance with its precedents and Common Law. As a result, discussing the statute of each state and United States possession is beyond the scope of this chapter.[175] Few states have a statute that specifically addresses the covenant not to compete within the context of the franchise relationship.[176] The statutes

174 *Capital Temporaries, Inc. v. Olsten Corporation*, 506 F.2d 658, 666 (Ct. App. 2d Cir. 1974).

175 The seminal treatise on this matter in relation to franchising is *Covenants Against Competition in Franchise Agreements* (Klarfeld, ed., 2d. ed., 2003).

176 Consider, however, the State of Illinois at 815 Ill. Comp. Stat 705/20, where, if a franchisor fails to renew a franchise, the state requires it to repurchase or compensate

regarding covenants not to compete in most states do have some elements in common with the statutes in other states.

Generally, the various states view covenants against competition as a violation of a citizen's fundamental right to work and have declared to be void (except in very limited circumstances) any contract or covenant that seeks to restrain or prevent a person from lawful exercise of a trade. In Colorado, for instance, the statute states plainly:

> "Any covenant not to compete which restricts the right of any person to receive compensation for the performance of skilled or unskilled labor... shall be void."[177]

As a result, with a few exceptions, covenants not to compete have been determined in Colorado to be contrary to "public policy".[178] Where legislation is interpreted as addressing a fundamental public policy, the courts in that state will interpret it in the strictest manner possible so as to grant the greatest protection to those covered by it. Thus, judicial review of such covenants most often starts from the position that it is void on its face.[179] In Colorado, covenants not to compete will only be enforceable if the relationship between the two parties falls within one of the stated exceptions[180] (so as to permit the covenant in the first place) and only then if the geographic, temporal, or other limitations are reasonable.[181]

As a result, most franchisors take great pains to insure that its covenants not to compete limit the franchisee from competing for a relatively short time only in a business that is substantially identical to the franchised business, for a relatively short time and then only in a geographic area that reasonably corresponds to the franchisor's interest in protecting existing franchised businesses from such competition.

Thus, a reasonably enforceable covenant will specifically call out the identity of a competing business (e.g., "a take-out and sit-down ice-cream parlor serving soft-serve frozen yogurt with a variety of products that can be mixed into the

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a franchisee for the lost value of its business and/or assets if there is a non-competition covenant in the agreement.

177 Colorado Revised Statutes, Section 8-2-113(2).

178 *DBA Entertainment, Inc. v. Findlay*, 923 P.2d 298 (Colo. App. 1996). Public policy matters are those standards and policies of the state that are deemed to be fundamental to the well-being of the citizenry.

179 *Phoenix Capital, Inc. v Dowell* 176 P.3d 835 (Colo. App. 2007).

180 Colorado Revised Statutes, Section 8-2-113(2). The Colorado statute identifies and carves out limited exceptions where covenants not to compete would be enforceable. These exceptions include: (i) asset purchase contracts where the purchaser seeks to prevent the seller from competing with him; (ii) contracts which seek to protect trade secrets; (iii) a covenant that permits an employer to recover the expense of training an employee if the employee has been working for less than two years; and (iv) covenants which prevent executive and management personnel from competing.

181 *Electrical Distributors, Inc. v. SFR, Inc.,* 166 F.3d 1074, 1076 (10th Cir. 1999).

yogurt" and not just "an ice cream store"); state that the franchisee is prohibited from competing in such a business for a reasonable period of time (periods of between six months and five years have been held enforceable); and limit the enforceability of the covenant to a specified geographic location (e.g., "within the franchisee's former exclusive territory or within the exclusive territory of any other franchisee of XYZ corporation").[182]

Furthermore, most such covenants also will contain what is called "blue pencil" language or a "savings clause". This language acknowledges that a franchisor may have overstepped its bounds by making a non-competition covenant too strict, and then permits the court to "rewrite" or blue-pencil the covenant to fashion one that is enforceable. Many courts have taken advantage of this right and have reduced the offending limitation in the covenant.

Notwithstanding the above, however, some states have, for the most part, banned franchised and non-franchised-based covenants not to compete. Amongst this group of states, California has the most comprehensive statutory protection for franchisees[183] and in this context has found that, for the most part, even well-drafted franchise-based covenants not to compete are unenforceable.

In *Robinson v. U-Haul Co. of California*, the court found U-Haul to have maliciously prosecuted the enforcement of its non-competition covenant since: ". . . no reasonable attorney would have thought tenable . . . " enforcement of the non-competition covenant in light of the strict interpretation given to its statute.[184] Indeed, California requires each California-registered FDD to have an admonition that states:

> "The franchise agreement contains a covenant not to compete which extends beyond the termination of the franchise. This provision may not be enforceable under California law."[185]

Other states may not have such a strict prohibition on covenants not to compete, but may limit their enforceability in other ways. In *Atlanta Bread Company v. Lupton-Smith et al.*, the Georgia Supreme Court found an in-term covenant not to compete was unenforceable because its geographic scope was too large.[186] In another Georgia case, the court found that if the covenant violates such strictures it is void *ab initio*, and blue-pencil language will not save it.[187]

182 Colorado recognizes the enforceability of a franchise-agreement-based non-competition covenant. See *Keller Corp. v. Kelley,* 187 P.3d 1133 (Colo. App. 2008).

183 *California Franchise Relations Act*, California Bus. and Prof. Code, Division 8, Chapter 5.5., Sections 20000–20043; and California Corporations Code, Title 4, Division 5, Sections 31,000–31516.

184 *Robinson v. U-Haul Co. of California, Business Franchise Guide* (CCH), para 14,481 ((Ct. App. CA 2010) (not chosen for publication).

185 *State of California Department of Corporations Guidelines for Franchise Registration*, 310.111 UFDD PACKET (10/07), see *Business Franchise Guide* (CCH), para 5050.

186 *Atlanta Bread Company v. Lupton-Smith et al.,* 285 Ga. 587 (GA. 2009).

187 *New Atlanta Ear, Nose & Throat Associates, P.C. v. Pratt*, 560 SE2d 268, 273 (2002) (where the court stated: "[t]he `blue pencil' marks, but it does not write.").

In addition to the covenants not to compete contained in the franchise agreement, it is typical that the franchisor will require the principals of a business-entity franchisee to sign a separate covenant not to compete or to acknowledge that he is covered by the covenant already in the franchise agreement under the theory that the principals of a franchisee fall within the exceptions to the ban of a "generic" non-competition covenants.

Restrictions on Transfer

It is typical for the franchisor to strictly control the transfer process (i.e., the process whereby the franchisee or principal operator transfers its interest in the franchise). This is a common sense approach since the franchisor wants to maintain the integrity of the system generally, and of the particular franchised business, by insuring that the transferee is capable financially and has sufficient business skills to operate the business.

It is common for such restrictions on transfer to also encompass the consequences of the death, divorce, or disability of the franchisee or its principal operator. The franchisor will require its consent to any such transfer. Usually, such consent for any transfer is predicated on:

- The franchisee's compliance with the franchise agreement as of the date of the request for the transfer;
- The payment by the franchisee of all sums then due to the franchisor;
- The franchisor's review of the proposed transferees business and financial qualifications;
- The commitment by the transferee to attend training and renovate the physical structure of the franchised business;
- The payment of a transfer fee;
- The signing by the franchisee of a general release; and
- The signing by the transferee of the then-current franchise agreement.

Of these requirements, the last two often generate the most controversy. A general release is an agreement which serves to release the franchisor from any known or unknown claims, damages, or losses that the franchisee may have suffered at the hands of the franchisor from the "beginning of time" (used as a method to insure inclusion of even the first casual meeting of a franchisor and a prospective franchisee where nothing of substance was discussed) to the date that the franchisee's relationship with the franchisor is terminated. All such agreements, however, must refrain from disclaiming any representations made by the franchisor in the franchise disclosure document.[188]

188 16 Code of Federal Regulations, Section 436.9(h). This has been a hallmark of the Revised Rule and must be included in the body of the franchise agreement and as a covenant in any general release.

In many of the registration states, the franchisor is prohibited not only from disclaiming the representations in the FDD but also from attempting to release any claims that would otherwise be enforceable under the franchise-specific statute of that state.[189]

Transferees also sometimes balk at having to sign a new franchise agreement since material portions of it such as royalties or advertising requirements may have changed over time. Nonetheless, it remains a standard requirement.

In at least one limited circumstance, the franchisor will not impose any significant conditions precedent to transfer. In the case where a sole proprietor later converts to a corporation, a limited-liability, or a similar business entity and so long as the original-named franchisee retains majority ownership and control, the franchisor will impose no restrictions other than it be notified and provided with sufficient written proof that such transfer meets the stated requirements. Many of the registration states have applicable statutes that prohibit the franchisor from preventing a transfer except in limited circumstances.

Collective Advertising

In most franchise agreements, the franchisor either actively creates, or retains the right to create, regional or cooperative advertising councils. Such groups are made up of franchisees whose territories are included in a larger advertising area. The franchisor will require such franchisees to use a portion of its required local advertising fee, or will allocate a portion of the national advertising fee that its collects, for such advertising.

These groups are typically ruled by majority vote and will place advertising that is calculated to be mutually beneficial to all participants. Franchisors will, in virtually all circumstances, retain the right to vet any proposed advertising before it is placed in the media to insure the content maintains the integrity and good will engendered by the marks.

Guarantees

Most franchisors require the principals of a business-entity franchisee to sign a personal guaranty. It also is common for such principal to be made subject to the restrictive covenants found in the franchise agreement, including the covenant not to compete.

Termination, Cancellation, and Non-Renewal of Contract

In the non-registration states, the FTC requires only that the franchisor disclose in Item 17 the specifics of its policy on termination, cancellation, and non-renewal. Typically, such states' franchise agreements call out a lengthy list of violations for which termination is the remedy. Some breaches come with a

189 *State of California Department of Corporations Guidelines for Franchise Registration,* 310.111 UFDD PACKET (10/07), *Business Franchise Guide*, Paragraph 5050.

time-limited right to cure (e.g., 30 days), while others result in immediate termination. Terminable-upon-occurrence missteps include: abandonment of the business; use of a mark in violation of the franchise agreement; distribution of proprietary information to unapproved parties; intentional misstatement of gross revenue; conviction of a crime of moral turpitude; and those similar in nature. Curable defaults often involve the negligent misstatement of gross revenue; late payment of royalties or advertising fees; and the failure to timely report financial data.

In the registration states, and in other states that have no registration requirement but do have franchise-specific "relationship" statutes relating to termination,[190] it is typical for statutes or regulations to limit the manner and method by which the franchisor can terminate or fail to renew a franchise relationship. Thus, the franchisor may be prohibited from terminating a franchisee without having "good cause" to do so. "Good cause" is defined by the state.

In California, "Good cause shall include, but not be limited to, the failure of the franchisee to comply with any lawful requirement of the franchise agreement after being given notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure the failure".[191] In Michigan, good cause includes ". . . failure of the franchisee to comply with any lawful provision of the franchise agreement and to cure such failure after being given written notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure such failure".[192] In the United States Virgin Islands, good cause includes the franchisee's failure to substantially comply with "essential and reasonable" covenants of the franchise agreement; and bad faith on the part of the franchisee.[193] In New Jersey, good cause "shall be limited to failure by the franchisee to substantially comply with those requirements imposed upon him by the franchise". Furthermore, in New Jersey, the franchisee must be given no less than sixty days written notice of the termination of or election not to renew the franchise".[194]

It is rare for a franchise agreement to be cancelable at the will of either franchisor or franchisee. Where it is seen, it tends to be in franchised businesses that do not require a large initial outlay of funds to open and that are not brick-and-mortar-based. Even then, the right to cancel is more often awarded only to the franchisee (but not the franchisor) and is predicated on the franchisee having been open and operating for a period of time (12 months or more).

190 See Table 4 for a list of such states.
191 California Franchise Relations Act, California Bus. and Prof. Code, Division 8, Chapter 5.5, Section 20020.
192 Michigan Compiled Laws, Section 445.1527(c) (2009).
193 Virgin Islands Code, Title 12A, Chapter 2, Sub-Chapter III, Section 132.
194 New Jersey Statutes Annotated, Section 56:10-5 (2010). There are exceptions: If the franchisee has abandoned the business, 15 days' notice needs be given and, if the franchisee is convicted of an indictable offense directly related to the business, termination may be immediate.

Franchisor's Liability for the Acts of the Franchisee

Until recently, it had been well-settled law in the United States that franchisors and franchisees are independent of each other such that the acts of one will not be imputed to the other.[195] Most franchise agreements identify the franchisees as independent contractors (and not agents or employees of franchisors) that are in charge of the day-to-day operations of the franchised business. Thus, the mere existence of the franchisor-franchisee relationship in which the franchisor exerts direction over the franchisee's use of its marks and proprietary information and control over such matters as trade dress, interior and exterior design motif, menu content, and the like has not in and of itself been considered sufficient to create an agency relationship.[196]

As a result, the most typical tort claims, liability for the criminal acts of the franchisee or its employees, breach of contract, or similar claims against a franchisee, have rested solely with the franchisee and could not be imputed to the franchisor under an agency or employee-employer relationship.

Notwithstanding the above, recent case law has eroded some of this bulwark. For instance, the United States District Court sitting in Massachusetts found a Texas-based commercial janitorial service franchisor to be the employer of its franchisees.[197] In that case, the franchisor would secure leads for the franchisees and would collect directly from the customer the cost of the services delivered by the franchisee. In turn, the franchisor would then pay the franchisee the money it collected, less royalties and any other fees due to it.

Under Massachusetts law, a person is deemed to be an employee unless he ". . . (a) is free from control or direction of the employing enterprise; (b) [the services are performed] outside of the usual course of business [of the employer], or outside of all the places of business, of the enterprise; and (c) [the person performs services] as part of an independently established trade, occupation, profession, or business of the worker".[198]

Franchisors of similar franchise business models have suffered the same fate.[199] As a result, in these instances, not only is the franchisor on the hook for various federally and state-imposed employment taxes (including back taxes and penalties for all of its franchisee/employees), but it also must manage its

195 *Viado v. Domino's Pizza,* 230 Ore. App. 531, 217 P.3d 199 (2009).

196 *Reese v. Dunkin' Brands, Inc*., *Business Franchise Guide*, Paragraph 14,190 (W.D. Tenn. 2009) (where the franchisor was not held vicariously liable for a sexual harassment claim against the franchisee's employee because the franchisor did not participate in the hiring, training, or discipline of the employee).

197 *De Giovanni et al. v. Jani-King International et al.,* 262 F.R.D. 71 (D. Mass 2009).

198 *De Giovanni et al. v. Jani-King International et al.,* 262 F.R.D. 71, 84 (D. Mass 2009).

199 *Awuah v. Coverall North America, Inc* , 707 F. Supp. 2d 80 (D. Mass 2010) (where the court found that Coverall, a competitor of Jani-King, failed to prove all three prongs of the employee test, and thus the court allowed the franchisee's employment-based claims to proceed to trial).

"employees", in this case from approximately 800 miles away.[200] Similarly, the misdeeds of the franchisee/employees can now be imputed directly to the franchisor as the employer.

In *State of California v. JTH Tax, Inc (D/B/A Liberty Tax Servic*e),[201] the franchisor mandated that its franchisees give the tax-preparation customers the opportunity to obtain their tax refund earlier than would be possible from the Internal Revenue Service, through a so-called "refund anticipation loan" or "RAL". With an RAL, the franchisee would prepare the customer's tax return and if a refund was anticipated would offer to pay such refund less the franchisee's costs and a fee for the service.

The attorney general for the State of California argued that the RAL and the direction and control that the franchisor had over the franchisee as manifested by the franchisor's operations manual,[202] which provides direction and control over the franchisee's training and other daily operations, were in excess of the control a franchisor must have over the franchisee to protect its marks and good will, the result of which is to make the franchisor liable for the franchisee's statutory violations.

This trend reached a crescendo in late 2014[203] when general counsel for the National Labor Relations Board (NLRB) [204] (the federal watchdog for labor relations in the United State) issued complaints against McDonald's (the franchisor), and several of its franchisees. The content of the complaints rocked the franchise world by stating that it would in certain franchise settings consider employees of the franchisee to be the "joint employees" of the franchisor.[205]

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200 As what may be perceived as a legislative response to the *De Giovanni* matter, the Virginia General Assembly is considering a bill (Senate Bill 34) that will prohibit employers from classifying employees as independent contractors. Although the bill does not expressly prohibit franchisors from using this classification, the question was asked of the Virginia Attorney General, who responded by stating that, generally, franchise relationships would not fall within the confines of the new law. *Business Franchise Guide*, Paragraph 14,537 (11 January 2011).

201 *State of California v. JTH Tax, Inc. (D/B/A Liberty Tax Servic*e), *Business Franchise Guide*, Paragraph 14,216 (California Sup. Ct. 2009).

202 *State of California v. JTH Tax, Inc. (D/B/A Liberty Tax Servic*e), *Business Franchise Guide*, Paragraph 14,216 (California Sup. Ct. 2009). All franchisors supply their franchisees with some form of operations manual. Most, if not all, manuals identify acceptable methods of daily operation of the business.

203 Ruling was handed down on 19 December 2014. See, generally, Leslie Patton, *McDonalds Told it Has Responsibility Over Store Workers,* Bloomberg Business (29 July 2014) which can be found at: http://www.bloomberg.com/news/articles/2014-07-29/nlrb-determines-that-mcdonald-s-is-employer-to-franchise-workers.

204 See, generally, the National Labor Relations Act of 1935 at 29 U.S.C. Sections 151–169 (2000).

205 See Steven Greenhouse, The New York Times, 29 July 2014 which can be found at http://www.nytimes.com/2014/07/30/business/nlrb-holds-mcdonalds-not-just-franchisees-liable-for-worker-treatment.html?_r=0; and Julie Jargon, Wall Street

General counsel complained that McDonald's (like virtually all franchised restaurant concepts — and indeed most retail franchised concepts) so controls such factors as employees' uniforms and the manner and method by which they cook and deliver food to customers as to rise to the level of becoming a joint employer with its franchisees.

Needless to say, the decision was met with immediate and scathing rebuttals.[206] Further, several noted franchise-law practitioners have published well-reasoned articles which squarely rebut the NLRB's stance and provide practical advice for reducing the risk.[207] Though this issue has simmered quietly in the past, with courts offering widely different takes on the same basic fact patterns,[208] it is now at the forefront of hot topics affecting franchising. As of the date of this article, no decision in the NLRB complaints has been made.

These cases and the decision by the NLRB highlight the difficulty that some have in distinguishing the unique franchise relationship from that of the traditional employer-employee relationship.[209] While it is true that the franchise agreement does require the franchisor to provide direction and control over more than the mere usage of the marks (as noted above, franchisors will provide detailed operations manuals to the franchisees the content of which will include standards and specifications for the day-to-day operation of the franchised business), it differs significantly from more traditional employment relationships when more closely analyzed. Franchisors do not actually operate the business; instead, the franchisee is left to perform that task. The franchisee and not the franchisor is responsible for:

- Hiring, training, and disciplining his employees;

Journal, July 29, 2014, available at http://www.wsj.com/articles/nlrb-decision-could-make-mcdonalds-liable-for-labor-practices-of-franchisees-1406660591.

206 Ed Brackett, *McDonald's Ruling Ignites Business-Labor Firestorm,* which can found at: http://www.usatoday.com/story/money/business/2014/07/29/mcdonalds-nlrb-franchises/13343125/; David Sherwyn, *What the NLRB's McDonald's Decision Got Wrong,* which can be found at: http://onlabor.org/2014/08/05/guest-post-what-the-nlrbs-mcdonalds-decision-got-wrong/ (5 August 2014).

207 See David J. Kaufmann, Felicia N. Soler, Breton H Permesly, and Dale A Cohen, "A Franchisor is Not the Employer of Its Franchisees or Their Employees*,"* 34 *Franchise Law Journal*, Number 4, p 439 (Spring 2015); and Rochelle Spandorf, *Twelve Tips for Licensors to Reduce Joint Employer Risks under Today's Legal Standards – Revisited,* Business Law Today (February 2016), which can be found at: http://www.americanbar.org/publications/blt/2016/02/06_spandorf.html.

208 Consider Martha Neil, *Seismic' 9th Cir. ruling nix FedEx claim its drivers aren't employees...*ABA Journal (27 August 2014), found at: http://www.abajournal.com/news/article/seismic_9th_circuit_ruling_calls_fedex_drivers_in_calif._employees_not_inde/; and *Patterson v Domino's,* 2014 Cal. LEXIS 9349 (28 August 2014).

209 *Supra.* notes 203–207 and Fournaris, "The Inadvertent Employer: Legal and Business Risks of Employment Determinations to Franchise Systems", 27 *SPG Franchise L.J.,* 224, 230 (2008) ("Franchising is a unique type of business arrangement. As such, a natural tension exists between the types of franchisor controls that are inherent in franchising and the types of control over day-to-day tasks that courts and regulators traditionally evaluate to determine whether an employment relationship exists.").

- Ordering and managing all inventory;
- Maintaining customer relations;
- Managing finances of the business;
- Complying with local, state, and federal laws; and
- Seeing to similar day-to-day operations.

Yet, the variations in interpretation of the relationship on a state-by-state basis make it impossible to totally insulate the franchisor from the possibility of being found to be an employer or principal in an agency relationship. The courts certainly look at cases involving vicarious or imputed liability on a case-by-case basis and may be swayed by the body of decisions nationwide that identify the franchisor-franchisee relationship as that of a principal to an independent contractor.

Protection and Safeguards for Franchisees

As noted, the purpose of the FDD is to provide a prospectus in a standardized form to prospective franchisees to insure both full disclosure of what the FTC identifies as the most important information necessary to make an informed business decision, and to permit the prospect to "compare apples to apples" when looking at several franchised business opportunities at one time. In the non-registration states, the failure to meet the requirements of the Revised Rule is left to the FTC to enforce, as there is no private right of action.

In cases where a violation is found to have occurred, the FTC has a variety of remedies available in the form of civil penalties (including fines), injunctive relief, criminal penalties, and rescission rights in favor of the franchisee.[210]

In most registration states, the injured franchisee has available both a state version of the FTCA and the state's franchise regulations from which to fashion a remedy. Under the franchise regulations, the aggrieved franchisee most often has a right to monetary damages and relief in both equity and the law.[211] In some cases, the state also can exercise its criminal jurisdiction for especially egregious violations.[212]

210 Federal Trade Commission Act, 15 United States Code, Section 57b(a)(1).

211 California Corporations Code, Section 31300: "Any person who offers or sells a franchise in violation of Section 31101, 31110, 31119, 31200, or 31202, or in violation of any provision of this division that provides an exemption from the provisions of Chapter 2 (commencing with Section 31110) of Part 2 or any portions of Part 2, shall be liable to the franchisee or subfranchisor, who may sue for damages caused thereby, and if the violation is willful, the franchisee also may sue for rescission, unless, in the case of a violation of Section 31200 or 31202, the defendant proves that the plaintiff knew the facts concerning the untruth or omission, or that the defendant exercised reasonable care and did not know, or, if he had exercised reasonable care, would not have known, of the untruth or omission".

212 California Corporations Code, Section 31404, and Indiana Code, Section 23-2-2.5-37.

Most states also have consumer protection legislation often identified as a "consumer protection act" and/or a "little Federal Trade Commission Act" (lFTCA). This title alludes to statutes that in many respects mirror the Federal Trade Commission Act. In turn, the statutes offer the general public and businesses with a private right of action[213] to bring claims based on such matters as unfair pricing by competitors, the sale to a consumer of a defective product, false advertising, and the like. In Colorado, a consumer was granted protection under the Colorado Consumer Protection Act[214] when the home they purchased turned out to be defective. Similarly, a Colorado franchisee of several restaurants invoked the Colorado FTCA in a failed attempt to prove fraud against the franchisor.[215] The Texas version of the FTCA[216] offers an aggrieved franchisee a cause of action against the franchisor for fraud in the inducement. Although most consumer acts grant protection only to the consumer, in Connecticut, the Connecticut Unfair Trade Practices Act[217] (CUTPA) covers both consumers and businesses.[218]

Fraud and Breach of Contract

Most cases brought by franchisees against the franchisor most often sound in fraud in the inducement and breach of contract. It is usual to see one case include both such claims.

The fraud claims, which many times are brought by a franchisee who is seeking to recoup losses after the franchise venture has failed,[219] often allege that the franchisor made illegal earnings claims or financial performance representations to the prospective franchisee in order to induce him to enter into the contract. Although each state may have a slightly different take, generally the elements of Common Law fraud are:

213 In Connecticut, the courts have agreed that a plaintiff may use the CUTPA even in case another statute may otherwise deny the party a private right of action. In *Conaway* v. *Prestia*, 191 Conn. 484, 491, 493, 464 A.2d 847 (1983), tenants were allowed to bring a CUTPA action even though they were denied a private right of action by statute to recover rent from their landlord. *Macomber* v. *Travelers Property & Casualty Corp.,* 261 Conn. 620, 645 and n.14, 804 A.2d 180 (2002) (evaluating plaintiffs' CUTPA claim predicated on violation of provision of Connecticut Unfair Insurance Practices Act, General Statutes, Sections 38a-815 *et seq*.).

214 C.R.S., Sections 6-1-101 *et seq*.

215 *Qdoba Restaurant Corporation v. Taylors, LLC* (D.C. CO 2010), *Business Franchise Guide*, Paragraph 14,361.

216 Texas Business and Commercial Code Annotated, Section 17.46(a). A false statement that induces a party to sign a contract may be a deceptive act for purposes of the Consumer Protection Act. *American Commercial Colleges, Inc. v. Davis,* 821 S.W.2d 450, 453 (Tex. Ct. App. 1991).

217 Connecticut General Statutes, Section 42-110b (a).

218 *McLaughlin Ford, Inc.* v. *Ford Motor Co*., 192 Conn. 558, 566-67, 473 A.2d 1185 (1984).

219 *Haynes Trane Service Agency v. American Standard, Inc.*, *Business Franchise Guide*, Paragraph 14,125 (10th Cir. 2009) (the franchisor was successful in terminating the franchisee for fraudulently retyping invoices in preparation for the franchisor's audit).

- False representation of a material existing fact;
- Knowledge on the part of the one making the representation that it was false;
- Ignorance on the part of the one to whom the representation was made of its falsity; and
- With the understanding that the representation was made with the intention that it be acted on and the result being that the representation caused a loss.[220]

The determination of the existence of fraud is, fact driven, and often is inconsistent from jurisdiction to jurisdiction. In *Colorado Coffee Bean, LLC et al. v. Peaberry Coffee et al.*,[221] the court found that the plaintiff franchisees could sue the franchisor defendant for fraudulently failing to disclose its parent company's losses. The court reasoned that the information was material as it could foreshadow the eventual insolvency of the franchisor. The court went further by noting that, irrespective of the facts:

- The old Rule (under which the disclosure document was drawn) did not require disclosure of a parent's financials;
- The franchise disclosure document and the franchise agreement both had covenants that cautioned the franchisee to not rely on any representations outside the four corners of the documents; and
- The franchisor's failure to disclose was actionable.

Breach of contract cases often involve claims and counterclaims that one party failed to perform under the franchise contract. Once again, though some state-by-state variations exist, the elements of a breach of contract claim in the United States generally are a legally enforceable obligation of the defendant to the plaintiff, and the defendant's violation of that covenant, resulting in a compensable loss.[222]

As with the fraud claims, the determination of the matter will be fact driven. For instance, in *Hockey Products and Services, LLC, et al. v. Total Hockey Worldwide, LLC*,[223] the franchisee claimed that the franchisor failed to provide post-opening advice or assistance with unusual operating difficulties.

The court dismissed the claim by noting that the franchise agreement contained no affirmative obligation of the franchisor to provide such services and, as a result, there could be no factual basis for a claim of breach. On the other hand, the court

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220 *Southeastern Colorado Water Conservancy District v. Cache Creek Mining Trus*t, 854 P.2d 167 (1993).

221 09CA0130 (Colorado Court of Appeals (2010), *Business Franchise Guide*, Paragraph 14,325 (CO C.A. 2010).

222 *Laboratory Corporation of America Holdings, v. Metabolite Laboratories, Inc.,* 599 F.3d 1277 (10th Cir. 2010).

223 *Business Franchise Guide*, Paragraph 14,531 (D.C. Minnesota, 2011).

in *Sherman et al. v. PremierGrarage Systems, LLC*[224] found that the plaintiffs did sufficiently plead the elements of a breach of contract claim against their franchisor as the franchise agreement could support a factual finding that the franchisor did breach a specific or implied covenant of the agreement.

Trade Marks

Trade marks, service marks, logotypes, and similar commercial marks are registrable federally under the Trade Mark Act of 1946,[225] which established the United States Patent and Trade Mark Office (USPTO), the so-called "Lanham Act",[226] and on a state-by-state basis under state statutes. A trade mark (a term commonly used to identify logos, "brands", trade marks, and service marks)[227] is:

> "A word, phrase, logo, or other graphic symbol used by a manufacturer or sell to distinguish its products from those of another."[228]

It can be expressed as a label, name, signature, word, letter or number, shape, packaging format, sound, or movement and in color, grey tones, or black and white so long as it can be graphically expressed. The purpose of filing a trade mark with the USPTO is to protect the trade mark right of control in all states of the nation (from the date of the filing forward) from any "confusingly similar"[229] trade mark that may be used by another.

The date of the filing is important since even in the presence of a federal filing, if another has used the same, or a commercially similar mark, prior to the federal filing, such user may have superior Common Law rights over the federal registration. Compare the federal filing to a state-only filing which will protect the mark only within the state in which it was filed; and, again, only from the filing date forward. Trade names[230] cannot be federally registered, though they may be registered on a state-by-state basis. Trade mark protection will not be afforded to:

- Marks that are confusingly similar (see text, above);

224 *Business Franchise Guide*, Paragraph 14,461 (D.C. AZ, 2010).

225 35 United States Code, Section 1; Rules of Practice in Trade Mark Cases, 37 Code of Federal Regulations, Section 2.

226 15 United States Code, Sections 1051 *et seq*. The Lanham Act, named after Texas Representative Fritz Lanham, was passed in 1946 and sets forth the procedures to obtain trade mark protection and the rights that a trade mark owner can enjoy.

227 A service mark is a trade mark that identifies and distinguishes sources of services instead of the source of a product.

228 *Black's Law Dictionary* (9th ed., p. 1630).

229 A mark is considered to be confusingly similar to another trade mark if it is likely to cause confusion, mistake, or deception in the minds of the public.

230 A trade name is merely the name used by a person to indentify his business or vocation. See, generally, *In re Letica Corp.*, 226 USPQ 276, 277 (TTAB 1985) ("[T]here was a clear intention by the Congress to draw a line between indicia which perform only trade name functions and indicia which perform or also perform the function of trade marks or service marks.").

- Marks that are generic, merely descriptive, or so general as to have no distinctive identity;[231]
- Marks that are merely functional product features;[232]
- Marks that are merely geographically descriptive;[233]
- Marks that are geographically deceptive;[234]
- Marks that improperly use or are unauthorized to use the name, symbol, or device of a statutorily identified organization;[235]
- Marks that consist or comprise immoral or scandalous matter[236] or which bring contempt or disrepute to a person, institution, belief, or national symbol;[237]

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231 15 United States Code, Section 1052(e)(1), precludes the use of descriptive marks. A mark is merely descriptive if it ". . . immediately conveys the ingredients, qualities, or characteristics of the good". For instance, calling a business the "ice cream shop" without further distinction would be considered too general and indistinct to permit protection.

232 In *Qualitex Co. v. Jacobson Products Co., Inc.,* 514 U.S. 159, 164-165, 34 USPQ2d 1161, 1163 (1995), the Supreme Court held that: "The functionality doctrine prevents trade mark law, which seeks to promote competition by protecting a firm's reputation, from instead inhibiting legitimate competition by allowing a producer to control a useful product feature. It is the province of patent law, not trade mark law, to encourage invention by granting inventors a monopoly over new product designs or functions for a limited time, 35 United States Code, Section 154, 173, after which competitors are free to use the innovation. If a product's functional features could be used as trade marks, however, a monopoly over such features could be obtained without regard to whether they qualify as patents and could be extended forever (because trade marks may be renewed in perpetuity)."

233 15 United States Code, Section 1052(e)(2), identifies a "primarily geographically descriptive" mark as one that is merely a geographic location (e.g., a city) that is known generally to the public and the public must make a goods/place association. For instance, in the matter of *In re London and Edinburgh Ins. Group Ltd.,* 36 U.S. P.Q. 2d 1367 (TTAB 1995), the mark "London and Edinburgh Insurance" was not registrable as being a mere geographic description.

234 15 United States Code, Section 1052(a). A mark is considered to be geographically deceptive if it would lead the consumer to associate the good or service with a particular geographic region when, in fact, it is not from that region. For instance, identifying a California sparkling wine as champagne is deceptive since such wine can only come from the Champagne region of France. See also, *In re California Innovations, Inc.,* 66 U.S.P.Q. 2d 1853 (Fed. Cir. 2003).

235 36 United States Code, Sections 53104, 3090, 8305, 1705, 2270, 130106, 5030, 22505, and 230105. The protected entities include the Boy Scouts of America, the American Legion, and the United States Olympic Committee.

236 15 United States Code, Section 1052(a).

237 15 United States Code, Section 1052(a). There is virtually no case law on what is "immoral". *In re McGinley,* 211 U.S. P. Q. 668 (CCPA 1981). The cases sidestep this quagmire by addressing the proposed marks scandalous. The standard used is that the mark must shock the sense of truth, decency, or propriety; or is disgraceful or offensive. *Harjo v. Pro-Football, Inc.*, 50 U.S.P.Q. 2d, 1705 (TTAB 1999), where the board found that the use of the word "redskin" when used in the context of a

- Marks that consist of a coat-of-arms or other insignia of a municipality, city, state, or country;[238]
- Marks identifying a particular living individual or a deceased president;[239]
- Marks that consist primarily of a person's surname;[240] and
- Marks not owned by the applicant.[241]

Assuming that it does not fall into one of the above categories, it must still be determined whether the mark is confusingly similar to one that is already registered. This can be accomplished be doing a search on the website of the USPTO,[242] by a search through the internet, and by using one of several on-line services that will perform a trade mark search of local, state, and national data bases.

Once the applicant has determined that the trademark has a likelihood of being registered, he or she will then make formal application to the USPTO.[243] Once filed, the application will be assigned to a USPTO attorney. This person will follow the well-established protocol for an in-depth substantive review of the application. This is a thorough procedure that often results in the issuance by the lawyer of an "office action" or letter that identifies for the applicant certain deficiencies in the filing. The same can range from a simple misidentification of a color or graphic of the mark, to an outright refusal for the violation of one of the above-identified categories. The more simple actions can often be resolved by telephone, email, or letter. The outright refusal requires a decision by the applicant to either abandon the mark or begin the lengthy appeal process.[244]

The appeals process starts with the attorney who issued the refusal. If one is unable to convince him that the mark can be registered, one can then petition the Commissioner of the USPTO to correct what one believes to be a procedural error made by the examiner, or to waive what may be an inconsequential portion of the rule when applied to the particular case.[245] This, again, is a more informal process. If an acceptable resolution is not realized at this juncture, the applicant then moves to the more formal and adversarial process of an appeal to the Trade mark Trial and Appeal Board (TTAB).[246] Such appeals must be filed within six

football team was a derogatory term of Native Americans, but that it was not shocking to the sense of truth, decency, or propriety.

238 15 United States Code, Section 1052(b).

239 15 United States Code, Section 1052(c).

240 15 United States Code, Section 1052(e)(4).

241 15 United States Code, Section 1051.

242 See http://www.uspto.gov/ ("search marks").

243 Filing for a trademark is most often done through the USPTO registration portal. See generally, http://www.uspto.gov/trademarks-application-process/filing-online.

244 See http://www.uspto.gov/trade marks/process/appeal/index.jsp.

245 TMEP, Section 1704, 37; Code of Federal Regulations, Section 2.146.

246 The TTAB "Trade Mark Trial and Appeal Board Manual of Procedure" (TBMP), is the handbook used by the TTAB to proceed in an orderly manner through the appeal.

months from the date of the final refusal or six months from the date of the action for which an appeal may be taken.[247] If one remains dissatisfied with the TTAB decision, the same can then be appealed to the United States district court or the United States Court of Appeals.

Assuming that the attorney approves of the proposed mark, it is then published for opposition in the *Official Gazette.*[248] Opposition will be mounted, if at all, by a person or entity that believes that the published mark should be denied registration. If no opposition is heard within 30 days, a certificate of registration will issue. Federally registered trade marks can realize protection indefinitely, so long as the owner of it files all periodically required affidavits of use.[249]

Federally registered trade marks are not automatically protected in foreign nations. If, however, the foreign nation is one of the 79 signatory countries[250] of the "Madrid Agreement Concerning the International Registration of Marks" (Madrid Agreement of 1891) and its companion the "Protocol Relating to the Madrid Agreement Concerning International Registration of Marks" (the "Madrid Protocol),[251] (which is a 1989 "filing treaty" to be used only for trade mark matters),[252] the holder of the United States trade mark will have a cost-effective way to obtain such protection through the delivery of a single application to a specific office.

See http://www.uspto.gov/web/offices/dcom/ttab/tbmp/. The TTAB also hears less formal *inter partes* ("between parties") appeals which are available when one perceives that he may be injured by a potential or actual filing. 15 United States Code, Sections 1067, 1070, and 1092.

247 37 Code of Federal Regulations, Section 2.142(a).

248 The *Official Gazette* (OG) is published every Tuesday and contains the trade marks and applicant's information that were approved in the prior week. See http://www.uspto.gov/web/offices/com/sol/og/2012/week29/TOC.htm.

249 These filings are first the Affidavit of Continued Use or Excusable Nonuse pursuant to 15 United States Code, Section 1058 (sometimes called a "Section 8" declaration), which is due at the end of the six-year period after the registration has been accepted, and then the Application for Renewal, pursuant to 15 United States Code, Section 1059, or the Combined Declaration of Continued Use and Application for Renewal which must be filed before the end of every 10-year period after the registration date. If one misses one of these deadlines and is unable to prove some form of excusable neglect, he will lose the rights to the mark.

250 This number is current as of September 2009. See http://www.wipo.int/export/sites/www/treaties/en/documents/pdf/madrid_marks.pdf. The Madrid Agreement and the Madrid Protocol is open to any country that is a signatory of the Paris Convention for the Protection of Industrial Property, which has been in existence since 1900. See http://www.wipo.int/treaties/en/ip/paris/trtdocs_wo020.html.

251 See http://www.wipo.int/madrid/en/legal_texts/trtdocs_wo015.html and http://www.wipo.int/treaties/en/registration/madrid/summary_madrid.html.

252 The Madrid Protocol is administered by the International Bureau of the World Intellectual Property Organization (WIPO), located in Geneva, Switzerland. See http://www.wipo.int/trade marks/en/.

The basic procedure necessary to obtain such international protection requires the completion of a uniform application,[253] which must then be delivered to the intellectual property governmental authority in the applicant's country (in the case of the United States, that would be the USPTO).

Applications will only be accepted if delivered by such governmental authority to the World Intellectual Property Organization (WIPO). The USPTO will certify that the information found in the WIPO application conforms to information filed originally with the USPTO when the applicant first applied for protection of the mark in the United States.[254]

Upon receipt, the proper WIPO authority will review the application to insure compliance with the Madrid Protocol. If it meets such requirements, the WIPO authority will publish the mark in the WIPO Gazette of International Marks,[255] and will send a certification of registration to the holder of the mark. WIPO also will notify the appropriate office of the "Contracting Party" nations[256] that were identified in the application. Each such registration is good for continuing 10-year periods after following the renewal procedure and paying the fee.[257]

Product Liability

Product liability statutes, Common Law, and litigation affect the franchise industry. The Restatement (Third) of Torts,[258] at Section 2, identifies several different areas of product liability, including liability for manufacturing defects (where the product fails to meet its intended design through faulty manufacturing), design defects (where foreseeable risks could have been avoided had the product been properly designed), and so-called "failure to warn" defects (where the injury could have been avoided had adequate instructions or warnings been issued).

Product liability cases most often apply to defective medical devices, automobiles, and other specialized fields of endeavor. For the most part, product liability is a matter of state law and state-based statutes concerning product liability, and Common Law. In limited cases, the federal government will step in to shield a certain class of products.

253 See http://www.wipo.int/madrid/en/forms/.

254 37 Code of Federal Regulations, Section 7.11, codifies the USPTO obligation in reference to the certification process.

255 See http://www.wipo.int/madridgazette/en/.

256 The Contracting Parties are the states that are signatories to the Paris Convention and who are identified by WIPO.

257 Much like a renewal with the USPTO, the WIPO renewal requires the filing of an application and the payment of a fee. See http://www.wipo.int/madrid/en/filing/renewal.html.

258 All United States restatements are published by the American Law Institute.

For instance, the Federal Biomaterials Access Assurance Act of 1998[259] (which preempts state law) protects suppliers of implantable medical devices by narrowing the definition of what would be deemed to be a defect.[260] Product liability cases are typically brought under one or more of four different causes of action, i.e., negligence,[261] breach of warranty,[262] misrepresentation,[263] or strict liability.[264]

Both negligence and misrepresentation cases are typically addressed through the settled precedent of the jurisdiction. As an example, a patron of a McDonald's restaurant sued the Virginia franchisee and its franchisor for negligently preparing a fried chicken sandwich when the sandwich doused him with hot grease.[265] Under Virginia law, the plaintiff was required to prove first that there was a standard of care in preparing the sandwich and that the franchisee through its employee breached that duty. The appeals court found that the trial court[266] erred in finding the absence of standard of care. Instead, the court agreed that there was a standard of care implied. Furthermore, the court went so far as to find that the franchisor, under certain circumstances, could be jointly liable with the franchisee for a breach of that standard if a sufficient agency relationship could be proven.

Breach of warranty claims also are resolved using both Common Law and state statute. Forty-nine of the states have adopted some form of the Uniform

259 21 United States Code Annotated, Sections 1601–1606.

260 *Geier v. American Honda Motor, Inc.,* 529 U. S. 861 (2000), where the United States Supreme Court denied an injured motorist the right to sue the manufacturer in state court because the Department of Transportation had impliedly preempted such right when it promulgated the National Traffic and Motor Vehicle Safety Act.

261 Negligence may be found where the actor failed to exercise the standard of care that a reasonably prudent person would have exercised under the same circumstances. It is proved by a preponderance of the evidence.

262 The breach of warranty refers to the failure of the franchisee and or franchisor to fulfill a written or oral promise concerning the performance or operation of the good or service.

263 Misrepresentation is often found where advertising represents the state or condition of a good or service which is deceptively different than the actual delivered good or product. An example would be "bait and switch" advertising, where the franchisee promises to deliver a good or service that is one of quality only to then deliver one of lesser quality by stating that the advertised good is no longer available. Here, the customer must represent that he relied upon the representations made to his detriment.

264 Of the four listed, strict liability is most difficult to prove but, if proved, has the greatest impact on the franchisee and franchisor. Strict liability does not depend on actual negligence or intent, but is based upon an absolute duty to manufacture a safe product or deliver a safe service. Thus, parties indirectly injured by a good or service may seek relief even though they were not the direct beneficiary of the good or product.

265 *Sutton v. Roth et al.* (CA 4th 2010), designated as not for publication; *Business Franchise Guide*, Paragraph 14,308.

266 The case was heard in the Federal District Court for reasons other than the federal preemption of the plaintiff's right to bring the state action.

Commercial Code (UCC).[267] The UCC is the one unified set of statutes and rules on sales of goods and other commercial transactions. Of the nine separate Articles of the Uniform Commercial Code, Article 2 ("Sales"), at Sections 2-313 ("Express Warranties"),[268] 2-314 ("Implied Warranty: Merchantability"),[269] and 2-315 ("Implied Warranty-Fitness for a Particular Purpose")[270] is most applicable.[271] For instance, a breach of express warranty was found where inspection tags attached to a failed fuel control valve falsely stated that the equipment had been inspected, tested, and repaired to the manufacturer's original specifications.[272]

The implied warranties found at Sections 314 and 315 coexist and augment each other.[273] Thus, the court in *Carpenter v. Donohoe*[274] found the plaintiffs were given an implied warranty because the defective home they purchased should have been merchantable and fit for a particular purpose (habitability) by being built in a workmanlike manner and with the proper materials. In *Gonzales v. Safeway Stores, Inc.*,[275] the court found that the seller of food for human consumption is held to impliedly warrant that the food is both merchantable (in the sense that it is being sold to the public as being wholesome) and is fit for a particular purpose — human consumption.

Franchise agreements are, in some cases, subject to interpretation under the Uniform Commercial Code. For instance, in *Liberty Lincoln-Mercury, Inc. v. Ford Motor Co.,*[276] the third circuit of the United States Court of Appeals found that the

267 The original text of the uniform law was published in 1952 through the joint efforts of the National Conference of Commissioners of Uniform State Laws (NCCUSL) and the American Law Institute. It is constantly updated. Each state has codified this uniform law. The Uniform Commercial Code is divided into nine separate categories. See http://www.law.cornell.edu/uniform/ucc.html.

268 Express warranties by the seller are created by any affirmative fact or promise to the buyer; any description of the goods that is made a part of the basis for the bargain; or any model or sample that is made part of the basis of the bargain. Colorado Revised Statutes (C.R.S.) 4-2-313.

269 "Unless excluded or modified (Section 316) a warranty that the good shall be merchantable is implied in a contract for their sale if the seller is a merchant with respect to goods of that kind."

270 "Where the seller at the time of contracting has a reason to know any particular purpose for which the goods are required and that the buyer is relying on the seller's skill or judgment . . . there is, . . . an implied warranty that the goods will shall be fit for such purpose."

271 Of the 50 states, Louisiana is the only state to have rejected the adoption of Article 2 in favor of its Common Law.

272 *Pegasus Helicopters, Inc., v. United Technologies, Corp.,* 35 F.3d 507 (10th Cir. 1994).

273 *Westric Battery Co. v. Standard Electric Co,* 482 F.2d 1307, (10th Cir. 1973).

274 388 P.2d 399 (Colo. 1964).

275 363 P.2d 667 (1961).

276 United States Court of Appeals, Third Circuit (1999), an unpublished opinion found at *Business Franchise Guide*, Paragraph 11,614.

express warranty language of Section 2-313 was of great value when exploring the existence of an express warranty in a franchise agreement between a dealer and the car manufacturer. Consider, however, *JRT, Inc. v. TCBY Systems, Inc.*,[277] where the court found that a franchise agreement was not a transaction concerning "goods"[278] within the meaning of the Uniform Commercial Code.

The theory of strict liability makes parties in a chain of distribution (including the manufacturer, the distributor, and the supplier) liable for a loss regardless of the allocation of fault. In *Union Supply Co v. Pust,*[279] for instance, the court enumerated the elements necessary to prove a strict liability design defect case, as follows:

- The product is in a defective condition unreasonably dangerous to the user or consumer;
- The product is expected to and does reach the consumer without substantial change in the condition in which it was sold;
- The design defect caused the plaintiff's injury;
- The defendant sold the product and is engaged in the business of selling products; and
- The plaintiff sustained damages.[280]

In that case, the only reason the manufacturer was not found to be liable was the distributor's failure to adequately prove that the product reached the consumer without substantial change. In the matter of *Holowaty v. McDonald's Corp. et al*,[281] the plaintiff who was injured when she spilled hot coffee on herself after purchasing it from McDonald's claimed that the franchisee and franchisor were strictly liable to her for a defective product (coffee that was too hot) and for failure to warn that the product could cause injury if spilled. McDonald's was successful in its defense against the defective product action as it proved that it maintained the temperature of its coffee at the standard expected in the industry. On the claim of failure to warn, the court also found in favor of the defendant. It ruled that:

> "Although a manufacturer has a duty to warn of reasonably foreseeable dangers, there is no duty to warn if 'the user knows or should know of potential danger'".[282]

277 52 F.3d 734 (8th Cir. 1994).

278 Goods are defined by the Uniform Commercial Code at Section 2-105 as being: ". . . all things . . . that are movable at the time of identification of the contract for sale. . . than investment securities. . . ".

279 583 P.2d 276 (Colo. 1978).

280 583 P.2d 276, 282-283 (Colo. 1978).

281 10 F.Supp. 2d 1078 (DC Minn 1998).

282 10 F.Supp. 2d 1078, 1081 (DC Minn 1998), which cites with approval *Fine Arts v. Parker-Klein Assoc. Architects,* 354 N.W.2d 816, 821 (Minnesota 1984).

Business Models and Taxation

Choices for Business Models

In General

In the United States, franchisees are generally able to purchase one or more of four different franchise models. Thus, the franchisor may:

- Grant a single franchise opportunity to a single person or business entity;
- Sell a multi-unit development agreement (often called an "area developer agreement") where a single franchisee agrees to open more than one unit in a given geographic area;
- Grant regional development rights, where a single franchisee is permitted to open its own franchise units and is required to first solicit prospective franchisees for the franchisor and, once the franchise agreement is signed between the franchisor and franchisee, to provide the franchisee some or all of the services that otherwise would have been delivered by the franchisor; and
- Grant a master franchise agreement where a "master franchisee" or "sub-franchisor" takes control of a geographic area (be it a state or the entire country) with the obligation to step into the shoes of the franchisor by soliciting all sales, signing all franchise agreements, and delivering all services that otherwise would be provided by the franchisor.[283]

In practice, few franchisors offer a master franchise opportunity within the continental United States since the franchisor is able to travel to all 48 states in a relatively short period, and is able to maintain greater control over the entire franchise relationship. On the other hand, franchisors that sell in Hawaii and Alaska or that are moving to the international markets are seeing the master franchise relationship as a viable alternative. In this way, the franchisor is saved the significant expense of having to police each individual franchisee in a country that may be tens of thousands miles away and language foreign to the franchisor. The reverse of this also holds true for foreign franchisors attempting to do business in the United States.

While it is possible for a foreign business entity to sell franchises from its home country under any one of the first two of the above methods, it is rarely done. First, remotely operated franchise systems suffer from having no one "on the ground" in the United States to timely respond to a franchisee's concerns. While there is always a mode of communication available, be it by telephone, email, or the like, time differences and language barriers make timely communications burdensome. Next, it may be economically impracticable to operate the system from a foreign county.

Consider that the franchisor is responsible for training, servicing, and auditing its franchisees to insure compliance with the franchise agreement, most all of

283 *Supra.* at notes 120–124.

which must be done at the franchisee's location. Sending representatives from the home country to the United States with all attendant food, lodging, transportation, and wage expenses to perform these services (which often must be done on a quarterly basis) would quickly become cost prohibitive.

In addition, adhering to the social and cultural norms, and complying with franchise regulations on both a federal and state level, would be hampered if there is no meaningful physical presence in the United States. Finally, it may be too difficult and costly to comply with taxation and business entity requirements necessary to permit a foreign business entity to earn revenue in the United States for later delivery of that revenue to a foreign country.

For all practical purposes, foreign business entities will instead either create a subsidiary business entity in the United States to operate as the franchisor, or will sub-franchise the rights to develop within the United States. Of these two options, it is more usual for a larger and more established foreign franchisor to set up a subsidiary, while its smaller counterpart may be happy granting a country-wide master franchise.

A stateside subsidiary of the parent business entity is itself a domestic business entity with its home office in one of the states. Subsidiaries are considered to be "affiliates" of the parent business entity. The term "affiliate" is defined in the Revised Rule as: ". . . an entity controlled by, controlling, or under common control with another entity".[284] It is typical for the foreign franchisor to set up shop in a state that may have particular attributes that are attractive to the franchisor, from acceptable weather to an advantageous tax structure.

The foreign franchisor will need a state-side franchise and business attorney[285] who can help with establishing the appropriate business-entity model (be it a corporation, limited liability business entity, partnership, or the like), and can help with the drafting of the FDD. It also is usual for the parent company to assign one of its senior personnel to head up the affiliate who, in turn, will often hire other senior-position personnel who have franchise experience in the United States. With the infrastructure in place, the affiliate can then set about performing the duties of a United-States-based franchisor.

On the other hand, smaller foreign franchisors that do not have the financial and administrative wherewithal to operate in separate countries can opt to sell one or more master franchise sub-franchise opportunities. A sub-franchisor is one who provides presale advertising and marketing services, signs the franchise agreement with the franchisee, and then provides all the services mandated by the franchise agreement. In all respects, the sub-franchisor substitutes for the franchisor. The advantage to the foreign franchisor is that it will have a franchisee that is knowledgeable and grounded in the social, cultural, and legal aspects of franchising, will be using the funding of the franchisee as the source

284 16 Code of Federal Regulations, Section 436.1(b).

285 The necessity of having legal counsel with extensive franchise industry experience cannot be overstated.

for the franchisor's expansion, and will avoid the necessity of having a physical presence in the country.

Sub-franchising, however, is not without its complications. In the non-registration states, both the franchisor and the sub-franchisor are required to prepare and distribute an FDD in accordance with the Revised Rule. Similarly, in the registration states, the franchisor and sub-franchisor will be required to comply with registration obligations. Although this is not an unsubstantial commitment in time and money, it is significantly cheaper for the franchisor than establishing a physical presence in the United States.

Protection of Marks

As part of establishing the business in the United States, the parent should have either registered the operative marks directly with the USPTO or, more likely, through the use of the Madrid Protocol mechanism. In turn, it will license the use of the marks to the affiliate or to the sub-franchisor.

This accomplishes the important task of separating the ownership of the marks from the assets of the franchisor and insures that, should the stateside venture fail, the use and good will of the marks in the rest of world will not be jeopardized.

Business Entities

Part of the organizational process for the franchisor that decides to open an affiliate in the United States is to determine the type of business entity that its affiliate is to adopt. As noted, there are a myriad of choices from setting up a corporation to creating a limited liability business entity.

Other than taxation rules, there are no national laws that regulate business entity choice. Instead, each state is permitted to set up the requirements that must be met to qualify and then register as a business entity. Generally, however, each state will recognize corporations, limited liability business entity registration,[286] partnerships (general and limited), joint ventures, and sole proprietorships.

Of those listed, only corporations, limited partnerships (as to the limited partners), and limited liability business entities offer the managers of the business entity and the holders of capital or equity positions protection from personal liability for the acts of the business entity.[287]

286 As a general statement, a limited liability company is a non-corporate business in which all "members" have, in the absence of a personal guaranty, limited liability for the acts of the business entity.

287 This is often called the corporate or limited liability "veil". In many states, piercing the limited liability veil in order to realize personal liability of the members can be accomplished in the same manner as piercing the corporate veil. See generally, *Sheffield Services Co. v. Trowbridge*, 211 P.3d 714 (Colo. App. 2009) and C.R.S. 7-80-107.

Although foreign franchisors also have the option of creating a joint venture, or a general or limited partnership with a stateside business partner, it is rarely done. The problems with the relationships, including the determination of which entity will be in charge, exposure to personal liability, the splitting of revenue, the inability of the foreign partner to be able to oversee the business on a day-to-day basis, and similar problems, cause the foreign party to shy away from such opportunities.

Taxation

Business entities domiciled in the United States are taxed federally and at the state, county, and municipal levels. For federal and state taxation purposes, corporate entities have a limited option of choosing the method by which its revenue is taxed. First, the entity can elect tax treatment as a "Sub-Chapter S" (or "S corporation") pursuant to Sub-Chapter S of Chapter 1 of the Internal Revenue Code of 1986.[288] Generally, the right to take advantage of this option is available only if:

- The business entity is a domestic corporation;
- It has "allowable" shareholders;[289]
- The business entity has no more than 100 shareholders;
- It has but one class of stock; and
- It is not an "ineligible" corporation.[290]

If it qualifies as an S corporation, the entity itself will pay no taxes on its revenue. Instead, all income, profits, losses, deductions, and credit are "passed through" to the shareholders in proportion to each person's percentage ownership of the stock. The shareholders then report the gain or loss to the Internal Revenue Service (Internal Revenue Service) who in turn pays taxes based on the shareholder's individual tax rates.[291]

Compare this to the "Sub-Chapter C" (or C corporation). The C corporation is taxed under Sub-Chapter C of the Internal Revenue Code[292] and is subject to

288 See generally the Internal Revenue Service website at www.irs.gov. It also can be found in 26 United States Code, Sections 1 *et seq*.

289 An allowable shareholder is a citizen of the United States and certain trusts and estates. The shareholders cannot be a business entity or a nonresident alien. 26 United States Code, Section 1361(b).

290 Ineligible corporations are certain financial institutions that use the reserve method of accounting for bad debts (e.g., a bank), insurance companies, and certain international sales organizations. 26 United States Code, Section 1361(b).

291 Individual tax rates in the United States range from 0 per cent to 35 per cent which, in turn, will be based on whether one is filing separately, as a married couple filing jointly, as a married couple filing separately, or as the head of a household. See http://www.irs.gov/ pub/irs-pdf/i1040tt.pdf and http://www.irs.gov/pub/irs-pdf/f1040es.pdf; 26 Code of Federal Regulations, Section 601.602.

292 26 United States Code, Section 301.

double taxation: once on the corporate level for the profit and losses that it incurs[293] and then on a shareholder level when the corporation issues a distribution or dividend. Each shareholder will then pay taxes based on his applicable tax rate. While the S corporation enjoys only a single level of taxation, it is subject to severe restrictions on who may own the shares. Thus, a foreign corporation will for the most part be relegated to choosing the C corporation as its business format.

For partnerships and joint ventures, the taxation will depend on whether the partnership is a general or limited partnership. The taxation of the joint venture will similarly depend on the structure of the joint venture — be it partnership, corporate, or limited liability venturers.

Limited-liability business entities are taxed in a variety of ways. Limited-liability business entities may have a single member or owner. In such an event, the business is treated as a so-called “disregarded entity”, with the result being that income tax consequences flow directly to the member/owner who will pay taxes based on his tax rate.[294] Unless otherwise chosen by the business entity, a limited-liability business entity with more than one member is treated as a partnership for tax purposes and, again, all tax consequences flow directly to the partners classified as a partnership and all revenue, profit, losses, and deductions.

Compare this to the C corporation, where its income will be taxed twice. Notwithstanding the foregoing, the limited-liability business entity may elect to be taxed as a C or S corporation. This decision will ultimately rest with the accountants of the business who would make a recommendation based upon a variety of factors, including the presence of employees, an election that may offer some form of tax shelter.

Foreign non-domiciled business entities that earn revenue in the United States also have to report to the Internal Revenue Service all funds that leave the United States for the entity’s foreign home.[295] Reporting such income is a highly complex procedure[296] that will most likely require the services of a certified public accountant that is knowledgeable in that area of taxation.

Generally, however, if the foreign franchisor was engaged in business in the United States (whether or not it realized income from the business) or was

293 The federal tax rate for corporations ranges from 15 per cent to 35 per cent. Corporate income tax is reported on Form 1120. See http://www.irs.gov/pub/irs-pdf/f1120.pdf and http://www.irs.gov/pub/irs-pdf/i1120.pdf.

294 Other taxes, such as employment taxes and certain excise taxes, are assessed against the business entity.

295 The foreign entity will file form 1120-F, see http://www.irs.gov/pub/irs-pdf/f1120f.pdf.

296 The instructions for the form comprise some 32 pages. Page 29 helpfully estimates the time it will take to keep the necessary records, to then learn about the law that applies, and to then prepare the form. In total, one must be prepared to spend literally hundreds of hours on this task. See http://www.irs.gov/pub/irs-pdf/i1120f.pdf.

not directly engaged in a trade or business but had income from any United States source (e.g., receiving royalty fees from a sub-franchisor, or receiving revenue from the affiliate), it must file a return. The tax rate is the same as for a domestic corporation of between 0 and 35 per cent of qualified income.[297]

Notwithstanding the above, the United States has tax treaties with foreign countries, which in turn may alter such reporting requirements. Publication 901 of the Internal Revenue Service[298] provides an overview of such treaties. Table 3 of the publication (current through 30 April 2010) lists 58 countries with whom the United States has reciprocal treaties. Although each such treaty will be somewhat different, all such treaties will:

- Identify the persons or business entities that are covered by the treaty;
- Identify the expense (e.g., the payment of interest on a debt) or the revenue (e.g., income, inheritance, or revenue subject to a value-added tax) that will be subject to the treaty;
- Identify methods by which to reduce the taxes on such revenue or will provide a credit for allowable expenses that are to be paid in the United States and/or the home country;
- Identify those businesses or persons for whom certain exemptions may be available; and
- Provide the procedural steps to be taken to take advantage of the treaty.

The ultimate goal of each such treaty on a federal level is to help the taxpayer reduce what otherwise would be multiple taxation of the revenue (first in the United States and then in the home country) and to permit it to take maximum advantage of a deduction. In all cases, however, a business entity in any form also will have its revenue taxed on the state[299] and in some cases on the municipal level. On a state basis, the income tax ranges from approximately one per cent to approximately 10 per cent of the corporation's state income. Municipal taxes may include the collection of taxes for local schools, fire and water districts, and the like. Such taxes may range from less than one per cent to five per cent or more of the persons' or entities' taxable income.

Until recently, it was standard for the states to waive taxation of revenue that was generated in a state if the recipient of the revenue (e.g., a franchisor whose home office is in another state) had no physical presence in that state. This standard is being eroded by cash-strapped states that are looking for new revenue source. Although there was some movement in this direction as early as 1993,[300] it has gathered momentum recently and has received the greatest press

297 Instructions to Form 1120-F, p 23, columns 2 and 3.

298 See http://www.irs.gov/publications/p901/ar02.html.

299 See http://www.taxadmin.org/fta/rate/corp_inc.pdf.

300 In 1993, the South Carolina Supreme Court determined that the Toys-R-Us franchisor was subject to the South Carolina income tax on the royalty revenue generated in that state because the mere presence of its intangible assets in the states

in the franchising industry from the matter of *KFC Corporation v. Iowa Department of Revenue*.[301]

In *KFC Corporation*, the fried chicken giant received revenue from its Iowa franchisees in the form or royalties. Such fees were delivered to the corporation's home state of Kentucky, where it then paid the Kentucky income tax. Although KFC had no physical presence in the state, in 2001, the Iowa Department of Revenue assessed the franchisor more than US $248,000 on its Iowa-based royalty revenue merely because it collected the funds from that state. *KFC Corporation* has been fighting ever since.

On 30 December 2010, the Iowa Supreme Court declared that in fact the corporation did have the equivalent of a physical presence in the state in the form of the intangible-property license it granted to each franchisee for the use of its marks. The matter was sent to the United States Supreme Court, which refused to review the finding, thereby making the lower court's decision final and unappealable.[302]

As a result, KFC will be required to pay the assessment plus all interest. Similarly, New York now requires its franchisors to report the identity of each of its franchisees and the gross revenue that each generated in the state[303] in contemplation of passing such a law. In California, the Franchise Tax Board has advised some franchisors to withhold seven per cent of all California-based royalty payments if the franchisor has not registered as a state business,[304] and in South Dakota has declared that while royalty revenue alone is not taxable, such revenue will be taxable if the fee is intertwined with a service or good.

Such bound services include the delivery of site selection help, on-site training, and on-line help services. Goods which would trigger such tax include the delivery of operations manuals, point of sale advertising materials, and the like.[305]

in the form of the licensed franchise relationship was sufficient nexus to permit the imposition. The United States Supreme Court refused to consider the case, thereby making the South Carolina decision final. *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13 (S.C. 1993); *certiorari* denied by the United States Supreme Court, 510 U.S. 992 (1993).

301 *KFC Corporation v. Iowa Department of Revenue*, 792 N.W. 2d 308 (IO 2010).

302 *KFC Corporation v. Iowa Department of Revenue*, 132 S.Ct. 97 (2011).

303 See the New York Laws of 2009, Subpart G of Part V-1 of Chapter 57. See also the state's memorandum on the filing requirements at http://www.tax.ny.gov/pdf/memos/sales/m09_9s.pdf.

304 See, http://www.allbusiness.com/government/government-bodies-offices-government/13678728-1.html.

305 Tax Facts # 165, July 2007, published by the South Dakota Department of Revenue and Regulations, 445 E. Capital Avenue, Pierre, SD 57501.

Pending Legislation

Several states have indicated an interest in the results of *KFC Corporation* and are considering presenting legislation to institute the above-described new layer of taxation.

There are no current plans for the FTC to make any significant changes to the Revised Rule, though it will continue to refine its use, interpretation, and application through the "Amended Franchise Rules FAQs"[306] and through informal FTC staff advisory opinions.[307]

Federally, legislation has been proposed that would make it unlawful for any "new" auto manufacturer to unreasonably discriminate against, or unreasonably deny a franchise to, a dealer in any case where the dealer applies within 60 days after the date of enactment of the legislation. This is aimed at such "new" automobile manufacturers as the retooled General Motors and Chrysler.[308]

Pending legislation in the states changes on almost a daily basis. A bill has been introduced in Colorado that would prohibit a manufacturer from terminating or modifying an automobile or power sport vehicle dealership without first providing 90-days' advanced notice.[309] Hawaii has extended the temporary reduction in its initial franchise filing fee from US $250 to US $125 until 1 January 2012.

306 See http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml.
307 See http://www.ftc.gov/bcp/franchise/netadopin.shtm.
308 House Bill H.R.75, which was referred to the House Committee on Energy and Commerce in January 2011.
309 Colorado House Bill 1188 (introduced 3 February 2011).

Table 1

State Specific

Registration, Filing, and Exemption Requirements

States that have a specific registration requirement

State	Title of Law	Statute
California	Franchise Investment Law	California Corporations Code, Title 4, Division 5, Parts 1-6, Sections 31000 - 31516 (Paragraph 3050)
Hawaii	Franchise Investment Law	Hawaii Revised Statutes, Title 26, Chapter 482E, Sections 482E-1-482E-5, 482E-8, 482E-9, 482E-11, and 482E12 (Paragraph 3110)
Illinois	Franchise Disclosure Act	815 Illinois Compiled Statutes, Sections 705/1-705/44 (Paragraph 3130)
Indiana[1]	Franchises Law	Indiana Code, Title 23, Article 2, Chapter 2.5, Sections 1-51 (Paragraph 3140)
Maryland	Franchise Registration and Disclosure Law	Annotated Code of Maryland, Article Business Regulation, Title 14, Sections 14-201-14-233 (Paragraph 3200)
Michigan[2]	Franchise Investment Law	Michigan Compiled Laws, Chapter 445, Sections 445.1501-445.1545 (Paragraph 3220)
Minnesota	Franchises Law	Minnesota Statutes, Chapter 80C, Sections 80C.01-80C.22 (Paragraph 3230)
New York	Franchises Law	New York General Business Law, Article 33, Section 680-695 (Paragraph 3320)
North Dakota	Franchise Investment Law	North Dakota Century Code Annotated, Title 51, Chapter 51-19, Sections 51-19-01-51-19-17 (Paragraph 3340)
Oregon[A]	Franchise Transactions Law	Oregon Revised Statutes, Title 50, Chapter 650, Sections 650.005-650.085 (Paragraph 3370)
Rhode Island	Franchise Investment Act	General Laws of Rhode Island, Title 19, Chapter 28.1, Sections 19-28-1-1-19-28.1-34 (Paragraph 3390)
South Dakota[3]	Franchises for Brand-Name Goods and Services Law	South Dakota Codified Laws, Title 37, Chapter 37-5A, Sections 37-5A-1-37-5A-87 (Paragraph 3411)
Virginia	Retail Franchising Act	Virginia Code, Title 13.1, Chapter 8, Sections 13.1-557-13.1-574 (Paragraph 3460)

State	Title of Law	Statute
Washington	Franchise Investment Protection Act	Washington Revised Code, Title 19, Chapter 19.100, Sections 19.100.010-19.100.940 (Paragraph 3470)
Wisconsin[4]	Franchise Investment Law	Wisconsin Statutes, Chapter 553, Sections 553.01-553.78 (Paragraph 3490)

1. A filing is required but is not reviewed.
2. A filing is required but is not reviewed.
3. A filing is required but is not reviewed.
4. A filing is required but is not reviewed.

A. No filing is required. The law, however, requires the franchisor to properly disclose prospective franchisees in the state.

States Requiring Filing of Form of Identification or Exemption from the State's Business Opportunity Law

State	Title	Statute
Florida	Franchises and Distributorships; Misrepresentations Law	Florida Statutes, Title 46, Title 817, Section 817.416 (Paragraph 3090); yearly identification filing.
Kentucky	Generally, Kentucky Business Opportunity Act, KRS 367.801, *et seq*.	One-time filing with Kentucky Attorney General
Texas	No Title	One-time filing with the Texas Secretary of State
Utah	No Title	Yearly filing as proof of exemption from the business opportunity law

Table 2

Registration State Exemptions

Juris-diction	Large Franchisee	Large Invest-ment	Fract-ional Franch ise	Small Fees	Insiders	Sale to Existing Franchisees	Single Sale
California	x		X	x	x	x	
Hawaii						x	
Illinois		x	X	x			
Indiana			X				x
Maryland		x		x		x	
Michigan			X	x		x	
Minnesota			X	x			x
New York			X			x	x
North Dakota							
Rhode Island	x				x	x	
South Dakota	x	x	X		x		

Juris-diction	Large Franchisee	Large Invest-ment	Fract-ional Franch ise	Small Fees	Insiders	Sale to Existing Franchisees	Single Sale
Virginia			X				x
Washington	x			x	x	x	x
Wisconsin		x	X	x		x	

Table 3

Business Opportunity States

State	Title	Statute
Alabama	Deceptive Trade Practices Act (a portion declares misrepresentations in the sale of seller-assisted marketing plans unlawful)	Alabama Code, Title 8, Chapter 19, Section 8-19-5, Sub-Section 20 (Paragraph 3018)
Alaska	Sale of Business Opportunities Law	Alaska Statutes, Sections 45.66.010-45.66.900 (Paragraph 3028)
California	Contracts for Seller Assisted Marketing Plans Law	California Civil Code, Division 3, Part 4, Sections 1812.200-1812.221 (Paragraph 3058)
Connecticut	Business Opportunity Investment Act	Connecticut General Statutes, Title 36b, Chapter 672c, Sections 36b-60-36b-80 (Paragraph 3078)
Florida	Sale of Business Opportunities Act	Florida Statutes, Chapter 559, Sections 559.80-559.815 (Paragraph 3098)
Georgia	Business Opportunity Sales Law	Official Code of Georgia Annotated, Title 10, Chapter 1, Article 15, Part 3, Sections 10-1-410-10-1-417 (Paragraph 3108)
Illinois	Business Opportunity Sales Law	815 Illinois Compiled Statutes Sections 602/5-1-602/5-145 (Paragraph 3138)
Indiana	Business Opportunity Transactions Law	Indiana Code, Title 24, Article 5, Chapter 8, Sections 1-21 (Paragraph 3148)
Iowa	Business Opportunity Promotions Law	Iowa Code Title XIII, Chapter 551A, Sections 551A.1-551A.10 (Paragraph 3158)
Kentucky	Sale of Business Opportunities Law	Kentucky Revised Statutes, Title XXIX, Chapter 367, Sections 367.801-367.819 and 367.990 (Paragraph 3178)
Louisiana	Business Opportunity Sellers and Agents Law	Louisiana Revised Statutes, Title 51, Chapter 21, Sections 51:1801-51:1804 (Paragraph 3188)
Maine	Regulations of the Sale of Business Opportunities Law	Maine Revised Statutes Annotated, Title 32, Chapter 69-B, Sections 4691-4700-B (Paragraph 3198)

State	Title	Statute
Maryland	Business Opportunity Sales Act	Annotated Code of Maryland, Article Business Regulation, Title 14, Sections 14-101-14-129 (Paragraph 3208)
Michigan	Consumer Protection Act (portion concerns business opportunities)	Michigan Compiled Laws, Chapter 445, Sections 445.902 and 445.903b (Paragraph 3228)
Nebraska	Seller-Assisted Marketing Plan Act	Revised Statutes of Nebraska, Chapter 59, Article 17, Sections 59-1701-59-1761 (Paragraph 3278)
New Hampshire	Distributorship Disclosure Act	New Hampshire Revised Statutes Annotated, Title XXXI, Chapter 358-E, Sections 358-E:1-358-E:6 (Paragraph 3298)
North Carolina	Business Opportunity Sales Law	General Statutes of North Carolina, Chapter 66, Article 19, Sections 66-94-66-100 (Paragraph 3338)
Ohio	Business Opportunity Purchasers Protection Act	Ohio Revised Code, Title 13, Chapter 1334, Sections 1334.01-1334.15 and 1334.99 (Paragraph 3358)
Oklahoma	Business Opportunity Sales Act	Oklahoma Statutes, Title 71, Chapter 4, Sections 801-829 (Paragraph 3368)
Oregon	The Oregon Unlawful Trade Practices Act expressly covers the advertising, sale, or rental of business opportunities	Oregon Revised Statutes, Title 50, Chapter 646, Sections 646.605-646.652 (Paragraph 3377)
Rhode Island	No statute of general applicability. Business opportunity sellers must comply with the FTC business opportunity rule	16 CFR, Part 436 (Paragraph 6030)
South Carolina	Business Opportunity Sales Act	Code of Laws of South Carolina, Title 39, Chapter 57, Sections 39-57-10-39-57-80 (Paragraph 3408)
South Dakota	Business Opportunities Act	South Dakota Codified Laws, Title 37, Chapter 37-25A, Sections 37-25A-1-37-25A-55 (Paragraph 3418)
Tennessee	The Tennessee Consumer Protection Act expressly covers distributorships and business opportunities	Tennessee Code Annotated, Title 47, Chapter 18, Sections 47-18-101-47-18-117 (Paragraph 3427)
Texas	Business Opportunity Act	Texas Business & Commerce Code, Title 4, Chapter 41, Sections 41.001-41.303 (Paragraph 3438)
Utah	Business Opportunity Disclosure Act	Utah Code Annotated, Title 13, Chapter 15, Sections 13-15-1-13-15-6 (Paragraph 3448)
Virginia	Business Opportunity Sales Act	Virginia Code, Title 59.1, Chapter 21, Sections 59.1-262-59.1-269 (Paragraph 3468)

State	Title	Statute
Washington	Business Opportunity Fraud Act	Washington Revised Code, Title 19, Chapter 19.110, Sections 19.110.010-19.110.930 (Paragraph 3478)

The District of Columbia Consumer Protection Procedures Law identifies business opportunities and a "good and service" and prohibits acts including passing off goods or services. See District of Columbia Code, Title 28, Chapter 39, Sections 28-3901-28-3908 (Paragraph 3517).

Table 4

States with Termination Statutes

State	Title	Statute
Arkansas	Franchise Practices Act	Arkansas Code of 1987 Annotated, Title 4, Chapter 72, Sections 4-72-201-4-72-210 (Paragraph 4040)
California	Franchise Relations Act	California Corporations Code, Division 8, Chapter 5.5, Sections 20000-20043 (Paragraph 4050)
Connecticut	Franchises Law	Connecticut General Statutes, Title 42, Chapter 739, Sections 42-133e-42-133h (Paragraph 4070)
Delaware	Franchise Security Law	Delaware Code Annotated, Title 6, Subtitle II, Chapter 25, Sections 2551-2556 (Paragraph 4080)
District of Columbia	The District of Columbia Consumer Protection Procedures Law	District of Columbia Code, Title 28, Chapter 39, Sections 28-3901-28-3908 (Paragraph 3517)
Hawaii	Franchise Rights and Prohibitions Law	Hawaii Revised Statutes, Title 26, Chapter 482E, Section 482E-6 (Paragraph 4110)
Idaho	Limitations on Right to Sue Law	Idaho Code, Title 29, Chapter 1, Section 29-110 (Paragraph 4120)
Illinois	Franchise Disclosure Act	815 Illinois Compiled Statutes. Sections 705/18-705/20 (Paragraph 3130)
Indiana	Deceptive Franchise Practices Law	Indiana Code, Title 23, Article 2, Chapter 2.7, Sections 1-7 (Paragraph 4140)
Iowa	Franchises Law; Franchise Agreements Law	Iowa Code, Title XIII, Chapter 523H, Sections 523H.1-523H.17 (Paragraph 4150); Iowa Code, Title XIII, Chapter 537A, Section 537A.10 (Paragraph 4152)
Maryland	Fair Distributorship Act	Annotated Code of Maryland, Title 11, Sections 11-301-11-307 (Paragraph 4200)
Michigan	Franchise Investment Law	Michigan Compiled Laws, Chapter 445, Section 445.1527 (Paragraph 3220.27)

State	Title	Statute
Minnesota	Franchises Law	Minnesota Statutes, Chapter 80C, Section 80C.14 (Paragraph 3230.14)
Mississippi	Franchises Law	Mississippi Code 1972 Annotated, Title 75, Chapter 24, Sections 75-24-51-75-24-63 (pyramid scheme provisions omitted) (Paragraph 4240)
Missouri	Franchises Law	Revised Missouri Statutes, Title 26, Chapter 407, Sections 407.400-407.410, 407.413, and 407.420 (pyramid scheme provisions omitted) (Paragraph 4250)
Nebraska	Franchise Practices Act	Revised Statutes of Nebraska, Chapter 87, Article 4, Sections 87-401-87-410 (Paragraph 4270)
New Jersey	Franchise Practices Act	New Jersey Revised Statutes, Title 56, Chapter 10, Section 56:10-1-56:10-29 (Paragraph 4300)
Tennessee	The Tennessee Consumer Protection Act	Tennessee Code Annotated, Title 47, Chapter 18, Sections 47-18-101-47-18-117 (Paragraph 3427)
Virginia	Retail Franchising Act	Virginia Code, Title 13.1, Chapter 8, Sections 13.1-557-13.1-574 (Paragraph 3460.08)
Washington	Franchise Investment Protection Act	Washington Revised Code, Title 19, Chapter 19.100, Section 19.100.180 and 19.100.190 (Paragraph 4470)
Wisconsin	Fair Dealership Law	Wisconsin Statutes, Chapter 135, Section 135.01-135.07 (Paragraph 4490)