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AVOIDING ACCIDENTAL FRANCHISES

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Introduction

California is one of fifteen states with laws that regulate offers and sales of franchises. These state laws exist against the backdrop of an FTC franchise sales and disclosure rule that applies nationwide. One effect of these laws is to require delivery of an offering prospectus and a cooling off period before a franchisor may lawfully enter into a franchise agreement.

Twenty states, including California, have laws that regulate the ongoing franchisor-franchisee relationship. These laws restrict a franchisor's freedom to end the relationship over the franchisee's objection, either during the agreement's term or at its expiration. To varying degrees, they also prohibit unfair practices in the franchisor-franchisee relationship.

Many business law practitioners do not concern themselves with franchise laws, assuming they apply only to transactions intended to be franchises, or involving multiple look-alike locations with periodic royalties to be paid. However, the franchise laws apply more broadly. Their reach can be surprisingly wide, with unanticipated effects.

This year, the court of appeal expanded the scope of liability for wrongfully terminating a franchise. *JRS Products, Inc. v. Matsushita Electric Corp.* (2004) 115 C.A.4th 168. Before the *JRS* decision, the last reported precedent held that the remedy for wrongful termination was to require the franchisor to buy back the franchisee's product inventory. *Boat & Motor Mart v. Sea Ray Boats* 825 F.2d 1285 (9th Cir. 1987). In *JRS* the California appellate court disagreed with the ninth circuit and held that a wider range of damages is available, equivalent to what would be recoverable for breach of contract.

The scope of the franchise laws is not intuitive. They impact a wider range of business transactions than some practitioners and clients recognize. The statutes are a source of claims and attention in the courts. So it is important for business law practitioners to have a basic understanding of the nature of a franchise relationship, and how a transaction can be structured to avoid the broad reach of the franchise laws.

What is a Franchise?

California law defines a "franchise" as an agreement in which (a) one person (a "franchisee") is granted the right to engage in a business offering, selling or distributing goods or services under a marketing plan prescribed by another person (the "franchisor"); (b) the licensee's business using the plan is substantially associated with the licensor's trademark; and (c) the licensee pays the licensor a franchise fee. Corps. Code Sec. 31005; Bus. & Profs. Code Sec. 20001. These elements are often referred to in a shorthand manner as a marketing plan, trademark license and franchise fee.

In their most common form, these elements combine into businesses that are familiar to lawyers and clients in the form of traditional quick service restaurant, gasoline station, hotel, real estate brokerage, and myriad other franchises. The typical franchise features a brand name (like McDonalds, Texaco, Marriott, or Century 21) displayed at separate retail units that are independently owned, but have a common appearance and operational procedures. The operator of each unit pays the franchisor a royalty for the privilege of using the name and business system.

Three California decisions signal the wide scope of the franchise laws.

- The scope of the trademark association element was expanded in *Kim v. ServoSnax* (1992) 10 C.A.4th 1346. The court of appeal held that the trademark element was satisfied in a licensing arrangement even though the originator's trademark (ServoSnax) was not communicated to the public or to

customers. The court found there was still a substantial association with a trademark because the brand name was important to facility owners in deciding whether to permit franchised locations to operate on their premises.

- The marketing plan element was found to be broad in *Gentis v. Safeguard Business Systems* (1998) 60 C.A.4th 1294. Gentis had sales representatives who solicited orders for Gentis' recordkeeping systems and office products and provided follow-up service. They did not control the terms of sales or close deals. They did not buy and resell goods, nor set sale prices and could not make binding agreements with customers. They did not handle billing or collection. The court still found that the sales representatives' role in taking orders amounted to the grant of a right to offer or sell goods under a system, which satisfied this element of a franchise relationship.

- The wide scope of the franchise fee element is illustrated by the 1987 *Boat & Motor Mart* decision mentioned above. The court said that payments made by a boat dealership to the manufacturer for promotional materials that are a common part of many product distributorships, like promotional films, banners, posters, and brochures, could be franchise fees.

Implications of the Accidental Franchise

It is unlawful to offer or sell a franchise in California or other states with registration laws, unless the offer is registered with the state or exempted from registration. Exemptions often require a franchisor to file an exemption notice and pay a filing fee. If an exemption is not available, an application for registration of an offer must be filed with the Department of Corporations. The application includes extensive information concerning the proposed franchise arrangement, the franchisor, persons associated with the franchisor, and financial information.

The application must be accompanied by an offering prospectus which discloses material information to prospective franchisees. When approved by the state, the prospectus, together with copies of all proposed agreements, must be provided to a prospective franchisee and a 10 business day cooling off period must elapse before the franchisee can sign any agreement or pay any money relating to the franchise. Corps. Code Sec. 31119. Additionally, under the FTC's franchise rule the offering circular must be presented no later than the first in-person meeting to discuss the possible sale of the franchise. 16 C.F.R. Sec. 436.2(g).

Unknowingly entering into a franchise arrangement creates unexpected risks and costs for all parties. Any person who offers or sells a franchise in violation of the registration, disclosure and cooling off requirements is liable to the franchisee for damages caused and in cases of willful violation, the franchisee is entitled to rescind the agreement and recover its investment. *See*, *Avcar v. Dollar System Rent-a-Car* 890 F.2d 165 (9th Cir. 1989). There are also civil and criminal sanctions, including possible felony prosecution. Corps. Code Sec. 31410; *People v. Gonda* (1982) 138 C.A.3d 775; *People v. Kline* (1980) 110 C.A.3d 597.

If a continuing business relationship is a franchise, a franchisor cannot lawfully terminate the relationship except in compliance with the Franchise Relations Act. As noted above, an appellate decision this year expanded the remedies for violation of the law's restrictions on terminating a franchise relationship. *JRS Products, Inc. v. Matsushita Electric Corp.* (2004) 115 C.A.4th 168.

Violating the franchise law, even inadvertently, can have other implications. When liability or a problem accrues later, a client may claim they were not properly advised by their lawyer. *See e.g.*, *Pyramid Controls v. Siemens* 172 F.3d 516 (7th Cir. 1999); *Beverly Hills Concepts v. Schatz, et al.* (Conn. 1998) 717 A.2d 724. In a future transaction, like a corporate sale or financing, an ignorant franchisor may not be able to represent, or get a legal opinion, that it is in compliance with all applicable laws. A company that discovers too late that it had

inadvertently granted a franchise may not be able to end the relationship, or may pay an unexpectedly high cost to end the relationship.

Some Other Unexpected Franchises

A farm equipment manufacturer learned this lesson at a high price. For over 20 years a dealer sold Mitsubishi forklifts. After Mitsubishi ended the relationship the dealer claimed it had been a franchise, protected from termination by state law. A jury found that a total of $1,600 paid over the 20-year relationship for sales and service manuals, was a franchise fee. This resulted in a $1.5 million damage award for wrongful termination. An appeals court noted that the specialized meaning given to the word "franchise" could surprise even sophisticated parties, as happened here. *To-Am Equipment Co. v. Mitsubishi* Forklift, 152 F.3d 658 (7th Cir. 1998).

Many other routine business transactions also implicate the franchise laws. The elements of a franchise may all be identified in the following examples:

- a trademark license in which the licensor provides significant assistance to the licensee, and receives payment of royalties or other fees;

- an original equipment manufacturer (OEM) agreement, in which the manufacturer/reseller is permitted to integrate, package and resell a licensor's product or service, together with its brand, where the licensor also provides guidance, and receives payment of an upfront fee or royalty;

- a wholesale sales program for consumer or other products, where salespeople follow a selling routine provided by the manufacturer and must buy samples or marketing materials to provide to their customers.

Surprises in this area are not hypothetical, or rare. In 2003 a Los Angeles jury awarded a plaintiff more than $6 million in a case in which the parties expressly agreed in writing that their arrangement was *not a franchise.*[1] The defense claimed the parties believed they were not and did not intend or want to be a franchise. See also, *Cooper Distr. Co. v. Amana Refrigeration*, 63 F.3d 262 (3d Cir. 1995) (appliance distributors); *Petereit v. S.B. Thomas Inc.*, 63 F.3d 1169 (2d Cir. 1995) (bakery goods); *American Bus. Interiors. v. Haworth*, 798 F.2d 1135 (8th Cir. 1986) (furniture); *Aristacar Corp. v. NY Atty. Gen.* (1989) 143 Misc.2d 551 (radio dispatched car service was a franchisor; drivers were franchisees).

How to Avoid Being A Franchise

Lawyers often represent clients in transactions in which the elements of a franchise may be present. A logical way to avoid application of the franchise laws is to then structure the transaction to eliminate one of the elements, so that the definition of a franchise is avoided. This means a choice of:

- Avoiding a marketing plan. If a transaction involves payment of fees together with the license of a trademark, then make sure it does not involve the right to distribute goods or services under a marketing plan provided by the entity granting the right. The most straightforward way to avoid this element is to offer no assistance, control or guidance to the other party to the transaction, except the bare minimum inspection rights that may be needed to protect the licensed trademark.

- Avoid the license of a trademark. If a business transaction involves permission to a party to distribute goods and services together with guidance or assistance amounting to a marketing plan, then prohibit the distributor from associating its business with the originator's trademark.

- Avoid a franchise fee. In this regard, in most states and under the FTC Rule, the mere payment for goods to be resold from inventory is not a franchise fee. Therefore, if a transaction involves the licensing of a trademark together with

distribution of goods or services, then limit the payment of any fees to only the payment of a bona fide wholesale price for goods to be resold.

- Open only company owned stores and expand distribution through the use of employees or sales agents. Employer-employee or principal-agent relationships do not normally include elements of a franchise. This is mainly because they do not involve payment of any kind of fee since the employer or principal typically pays the employee or agent for their services.

There are more ways to avoid or reduce the effect of the franchise laws. In a transaction that a practitioner believes should not be subject to the law, it is possible to request an interpretive opinion from the Department of Corporations confirming that the law does not apply (Corps. Code Sec. 31510), and a transaction conducted in accordance with that opinion enjoys immunity from liability under the law. Corps. Code Sec. 31511.

The franchise laws also include exemptions that can be the basis for structuring a transaction to avoid the law's most onerous provisions. The major exemptions apply to:

- The sale of a franchise by a franchisor whose net worth exceeds $5 million (or whose net worth exceeds $1 million if its parent's net worth exceeds $5 million). Certain limited disclosure and filing requirements apply. Corps. Code Sec. 31101.

- The offer or sale of a franchise, which is made by a franchisee for its own account. This exemption applies most often to permit an acknowledged franchisee to sell its franchise, without being required to comply with the franchise registration, disclosure and cooling off period procedures. Corps. Code Sec. 31102.

- The offer or sale of a franchise where the purchaser is not a California resident, and the franchise will operate entirely outside the state. Corps. Code Sec. 31105. This provides an exemption from California's law, but care must be taken in case the other state(s) involved have franchise laws that may apply.

- The offer or sale of a franchise to a purchaser who has substantial experience in the ownership and operation of a similar business. Typical requirements under the law are that the purchaser have at least two years experience in the same type of business, or have been an officer of the franchisor for at least two years. Corps. Code Sec. 31106.

- The offer of a franchise that is merely the addition of a product or service to an existing business, where the parties do not expect that the additional product or service will account for more than 20% of the sales of the existing business. Corps. Code Sec. 31108.

<u>Conclusion</u>

The franchise laws can have a surprisingly broad reach. In transactions that may potentially include the grant of a right to distribute products or services with the use of a trademark and guidance or a marketing plan, in exchange for any kind of fee, the business lawyer should consider whether the franchise laws may apply. If so, then franchise law compliance may be needed. As an alternative it may be possible to structure the transaction to avoid at least one of the elements that make the relationship a franchise, or to fit within the requirements from an exemption.

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[1] The author testified as an expert witness, and the jury found that the relationship was a franchise notwithstanding this agreement. *LASVN #2 v. Sperry Van Ness Real Estate* (L.A. Superior Court Case No. BC 206251).