DRAFTING DISTRIBUTION AGREEMENTS: THE UNWITTING SALE OF FRANCHISES AND BUSINESS OPPORTUNITIES

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I. INTRODUCTION

It does not occur to most attorneys who are asked to draft or revise an agreement for the distribution of goods or services to ask whether the agreement constitutes the sale of a franchise or business opportunity. Yet, the failure to address this legal issue may lead to grave consequences for the client and, sometimes, for the attorney as well. Difficulties may arise because numerous state and federal


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1. In its simplest terms, a franchise is a license from the owner of a trademark or trade name permitting another to sell a product or service under that name or mark. G. Glickman, Franchising § 2.01 (1986) [hereinafter cited as Glickman]. See Evans v. S.S. Kresge Co., 394 F. Supp. 817 (W.D. Pa. 1975), rev’d on other grounds, 544 F.2d 1184 (3d Cir. 1976); Susser v. Carvel Corp., 206 F. Supp. 636 (S.D.N.Y. 1962). In Evans, the fact that Kresge did not sell goods or services to plaintiff did not preclude a franchise-type arrangement since that concept may apply to a method of doing business as well as to a method of distributing a particular product or line of product.

2. “Business opportunity laws ordinarily regulate sales of opportunities to engage in new or additional business enterprises.” P. Zeidman, P. Ausbrook & H. Lowell, Franchising: Regulation of Buying and Selling a Franchise A-79 (BNA Corporate Practice Series No. 34, 1983) [hereinafter cited as Zeidman, Ausbrook & Lowell].
laws and regulations apply to franchises and business opportunities. The consequences of a franchise or business opportunity will thus vary according to whether federal law, state law, or both regulate the relationship.3

In the eyes of some individuals, franchises are granted only to the proprietors of fast-food establishments. The more enlightened realize that franchising is used to establish other forms of businesses, such as muffler shops, employment agencies, and convenience food stores, among others.4 This type of franchise is commonly known as a "business format" or "package" franchise; the franchisor typically provides the franchisee with the business format, or a total package, for operating the business.5

What most people, including many attorneys, fail to realize is that a franchise may also be any form of product or service distribution arrangement in which the franchisee is identified with the provider of the goods or services. Some examples of this type of franchise are gasoline stations,6 motor vehicle dealerships,7 soft drink bottling companies,8 office machine dealerships,9 and real estate sales

3. For analyses of the relationship between state and federal franchise laws, see Cantor, The Federal and State Regulation of Franchises (Pts. 1 & 2), 27 PRAC. LAW. (No. 6) 55 (1981), and 27 PRAC. LAW. (No. 7) 77 (1981); Downs, Franchise Regulation: Comprehensive State Regulation Now Unnecessary, 49 UMKC L. REV. 292 (1981); Mackey & Kurylak, Interfaces of the FTC Trade Regulation Rule and State Franchise Laws, 1980 ARIZ. ST. L.J. 527; Rudnick & Young, A Primer on the Regulation of Franchise Sales, 1980 ARIZ. ST. L.J. 453; ABA Section of Antitrust Law, Franchising Committee, Franchising as a Distribution Channel: Outline of Relevant Law, 49 ANTITRUST L.J. 791 (1981). Federal franchise regulation by means of the "FTC Rule" is discussed infra notes 23-27 and 70-85 and accompanying text. State franchise regulation is discussed infra notes 28-53 and 96-128 and accompanying text.


5. See id. at 3; ZEIDMAN, AUSBROOK & LOWELL, supra note 2, at A-5. See also Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966 (1979) [hereinafter cited as Final Guides].


7. See Franchising in the Economy, supra note 4, at 1; Statement of Basis and Purpose, supra note 6, at 59,698.

8. See Franchising in the Economy, supra note 4, at 1.

companies. In this arrangement, usually known as "product" or "tradename" franchising, the franchisee is ordinarily responsible for devising its own methods of operation but is required to sell products and services supplied directly or indirectly by the franchisor.

Furthermore, a lack of understanding exists as to what constitutes a business opportunity. Business opportunities are typically thought of as classic schemes such as vending machine routes, businesses involving the assembly of parts in the home, and other home-cleaning service opportunities. They may also be more "hare-brained" schemes such as rabbit breeding businesses, earthworm farms, and greenhouse flower growing businesses. However, other more visible and viable businesses, such as moving van dealerships, security installation businesses, electronic amusement machine routes, and chemical distributorships often begin through the sale of business opportunities.

10. See Real America Real Estate Corp., Bus. Franchise Guide (CCH) ¶ 6428 (Apr. 9, 1982).
11. See Franchising in the Economy, supra note 4, at I; ZEIDMAN, AUSBROOK & LOWELL, supra note 2, at A-5; Final Guides, supra note 5, at 49,966.


An agreement for the distribution of goods or services may take an infinite number of forms and still constitute a franchise and/or business opportunity. The most common scenario leading to the inadvertent sale of a franchise or business opportunity is one in which a manufacturer, producer, assembler, importer, refiner, publisher, or any provider of services (“seller”) desires to reach new markets by selling to a third party the right to be the seller’s “distributor” in a selected territory. ¹⁸ To accomplish this objective, the practitioner may draft an agreement containing provisions which will subject the agreement and the relationship it creates to the franchise and/or business opportunity laws. It matters not what the agreement is called or what terms are used in the agreement to identify the parties. ¹⁹ For example, a franchise or business opportunity may exist even though the relationship is stated to be with a distributor, dealer, representative, sales representative, area representative, sales agent, manager, wholesaler, jobber, or licensee. ²⁰ All that is necessary for such an arrangement to exist is for certain characteristics—which will vary from statute to statute—to be present in the business relationship.

Even if these characteristics are present so that a franchise or business opportunity exists, it is conceivable that neither party will ever know of such characterization or its legal consequences. If the seller enters into a large number of such relationships, however, it is likely that it will eventually discover the error of its ways through a lawsuit brought by the distributor, or an enforcement action brought by federal or state authorities alleging that the seller unlawfully engaged in the offer and sale of franchises or business opportunities. ²¹ The seller may also discover that it has accidentally created a franchise when state law enjoins it from terminating or declining to renew a distributor. ²²

¹⁸ See Glickman, supra note 1, at § 2.01.
¹⁹ See id. (citing Final Guides, supra note 4, at 49,966).
²² Approximately 17 state laws prohibit the termination and/or nonrenewal
To avoid such surprises, companies utilizing distributors (and their lawyers) must be familiar with the requisites of the franchise and business opportunity laws. They must be particularly familiar with the definitional sections because these determine whether the relationship is subject to the laws. In many cases, proper counseling can enable a company to structure its agreements in a manner which still achieves the desired business objectives but avoids coverage under these statutes. If coverage is unavoidable, however, the franchise or business opportunity agreement should be drafted to comply with the applicable statutes and a sales compliance program should be established.

II. The Basic Framework

A. Federal

On the federal level, the sale of franchises and business opportunities is regulated by the Federal Trade Commission’s Trade Regulation Rule (FTC Rule) entitled “Disclosure Requirements and Prohibition Concerning Franchising and Business Opportunity Ventures.”

The FTC Rule requires franchisors (including sellers of

  


23. 16 C.F.R. § 436.1 [hereinafter cited as FTC Rule]. This Rule was promulgated pursuant to § 5 of the Federal Trade Commission Act, 15 U.S.C. § 41 (1982), and became effective in October 1979.

24. 16 C.F.R. § 436.2(c) defines franchisor as follows: “The term 'franchisor' means any person who participates in a franchise relationship as a franchisor, as denoted in paragraph (a) of this section.”

Section 436.2(a) provides in pertinent part:

(a) The term ‘franchise’ means any continuing commercial relationship created by any arrangement or arrangements whereby:

(1) (i) (A) a person (hereinafter “franchisee”) offers, sells, or distributes to any person other than a “franchisor” (as hereinafter defined), goods, commodities, or services which are:

(2) Indirectly or directly required or advised to meet the quality standards prescribed by another person (hereinafter “franchisor”) where the franchisee operates under a name using the trademark, service mark, trade name, advertising or other commercial symbol designating another person (hereinafter “franchisor”); and

(B)(I) The franchisor exerts or has authority to exert a significant degree of control over the franchisee's method of operation, including but not limited to, the franchisee's business organization, promotional activities, management, marketing plan or business affairs; or
business opportunities) throughout the nation to furnish an offering circular (sometimes called a "disclosure document" or "prospectus") to prospective purchasers. The offering circular must contain detailed information which the FTC has determined is necessary to enable prospective purchasers to make an informed decision concerning the purchase of the franchise. The FTC Rule further pre-

(2) The franchisor gives significant assistance to the franchisee in the latter's method of operation, including, but not limited to, the franchisee's business organization, management, marketing plan, promotional activities, or business affairs; provided, however, that assistance in the franchisee's promotional activities shall not, in the absence of assistance in other areas of the franchisee's method of operation, constitute significant assistance; or

(ii)(A) A person (hereinafter "franchisee") offers, sells, or distributes to any person other than a "franchisor" (as hereinafter defined), goods, commodities, or services which are:

(1) Supplied by another person (hereinafter "franchisor"), or
(2) Supplied by a third person (e.g., a supplier) with whom the franchisee is directly or indirectly required to do business by another person (hereinafter "franchisor"); or
(3) Supplied by a third person (e.g., a supplier) with whom the franchisee is directly or indirectly advised to do business by another person (hereinafter "franchisor") where such third person is affiliated with the franchisor; and

(B) The franchisor:

(1) Secures for the franchisee retail outlets or accounts for said goods, commodities, or services; or
(2) Secures for the franchisee locations or sites for vending machines, rack displays, or any other product sales display used by the franchisee in the offering, sale, or distribution of said goods, commodities, or services; or

(3) Provides to the franchisee the services of a person able to secure the retail outlets, accounts, sites or locations referred to in paragraphs (a)(1)(ii)(B)(1) and (2) of this section . . . .

25. Id. § 436.1(a).

26. The basic disclosure requirements set forth at 16 C.F.R. §§ 436.1(a)(1)-(20), require a franchisor to provide background information about its officers and directors, including litigation and bankruptcy history; details about the goods/services to be sold and costs to be incurred by the franchisee; the franchisee's obligation to purchase goods/services from the franchisor or other approved sources; term, termination, and renewal provisions; statistical information on the number of other franchises which have been sold by the franchisor; the franchisor's financial data; and records supporting claims of sales, profits, or earnings made by the franchisor. See Final Guides, supra note 5, at 49,972-82 (explanation of disclosure provisions); Statement of Basis and Purpose, supra note 6, at 59,639-82 (same). The requirements for the making of options sales, profits, and earnings claims appear in the FTC Rule at § 436.1(b)-(3). The earnings claim requirements are explained in the Final Guides, supra note 5, at 49,982-85, and in the Statement of Basis and Purpose, supra note 6, at 59,684-95.
scribes the format for and the times at which this information must be furnished to prospective franchisees.27

B. State

Fifteen states regulate the offer and sale of franchises,28 and twenty-one states regulate the offer and sale of business opportunities.29 Additionally, seventeen states regulate the relationship between

27. A franchisee is defined as "any person (1) who participates in a franchise relationship as a franchisee, as denoted in paragraph (a) of this section, or (2) to whom an interest in a franchise is sold." 16 C.F.R. § 436.2(d).

The format for disclosure is set forth in the FTC Rule, 16 C.F.R. § 436.1(a)(21)-(24). The Commission has decided to accept as an alternative to the FTC Rule format of disclosure the Uniform Franchise Offering Circular (UFOC) format prescribed by the North American Securities Commissioners Association (formerly the Midwest Securities Commissioners Association). See Final Guides, supra note 5, at 49,970-71.

Written disclosure must be furnished at the earlier of the "first personal meeting" or the "time for making of disclosure." The "time for making of disclosure" means ten business days prior to the earlier of (a) execution by a prospective franchisee of any franchise or other binding agreement relating to the sale or proposed sale of the franchise; or (b) payment by a prospective franchisee of consideration. The timing requirements of the FTC Rule are discussed in 16 C.F.R. §§ 436.1(a), .2(g), and .2(o); Final Guides, supra note 5, at 49,970; and Statement of Basis and Purpose, supra note 6, at 59,712.

For the format and timing requirements for the making of earnings claims, see references for earnings claims cited supra note 26.


a franchisor and a franchisee, most notably by restricting a franchisor's right to terminate or deny renewal of the franchise.

1. Franchise Registration/Disclosure

State laws regulating the sale of franchises generally require not only the furnishing of a detailed offering circular, but also that the offer be registered with state franchise authorities prior to any attempt to solicit prospective franchisees. Registration is accomplished by submitting a registration application and specified filing fees to the state franchise authorities. The application contains a variety of documents, the contents of which will differ from state to state. The heart of every application, however, is the offering circular. Applications must ordinarily contain copies of all advertising and promotional literature which the franchisor proposes to use, as well as identification of and information about all persons who will sell


31. See supra note 22.

32. For most franchisors, the offering circular used to comply with the FTC Rule can be used to comply with a state law if it is modified in accordance with certain statutory, regulatory, and administrative requirements applicable to franchising in that state. Zeidman, Ausbrook & Lowell, supra note 2, at A-53.

33. See H. Brown, Franchising, Realities and Remedies 177 (2d ed. 1978). Such state procedure is immeasurably superior to the FTC process. First, it provides the administrative agency [usually the attorney general, a consumer protection agency, or a securities commission] with an opportunity to examine the registration information to assure that it meets the regulatory standards. Second, it provides the very important sanction of public exposure. Neither of these critical sanctions is provided in the FTC Rule.

Id.

34. Franchise registration commences with the submission of the registration application to the state franchise administrator. See Zeidman, Ausbrook & Lowell, supra note 2, at A-52. See id. at A-52 to A-75 (complete discussion of the registration process).

35. The offering circular, financial statements, signature pages, a form identifying any proposed advertising to be done in the state, and a filing fee form are a few of the major documents which must be included in the registration application. These documents will differ in content from state to state. Id. at A-52 to A-73.
the franchises. All of this information and material must be approved by the state authorities prior to the offer of any franchise.

2. Substantive Franchise Laws

Franchise laws regulating the relationship between a franchisor and a franchisee are sometimes called "substantive" franchise laws. They are most notable for requiring franchisors to have good cause prior to terminating or declining to renew a franchise. These provisions may also require franchisors, even if good cause such as a default exists, to provide notice and an opportunity to cure prior to termination or nonrenewal.

The substantive laws also regulate many other aspects of the franchise relationship, primarily by affording greater protection to franchisees on the theory that franchise laws are designed to correct an imbalance in the franchise relationship. For example, it is unlawful for a franchisor to: unreasonably prohibit the transfer or assignment of a franchise; discriminate unfairly among franchisees; fail to repurchase items upon termination or nonrenewal; engage in unreasonable conduct and unfair dealings with franchisees; interfere with free association among franchisees; violate the fran-

36. See id. at A-69 to A-71. Advertising must be submitted to state authorities for review several days prior to its initial use in that state. The specified number of days varies from state to state, with as little as three days in California to 15 days in Maryland. Id. at A-69.

37. See id. at A-69 to A-71.

38. See, e.g., Fine, Recent Developments in State Law Affecting Franchising, 1980 Ariz. Sr. L.J. 547, 550 ("Some states have gone beyond mere disclosure, however, and have enacted legislation which specifically governs some of the substantive terms of franchise agreements.") [hereinafter cited as Fine].


40. See, e.g., Ark. Stat. Ann. § 70-811 (franchisee has 30 days to rectify repeated deficiencies and void notice of termination, cancellation, failure to renew); Cal. Bus. & Prof. Code § 20020 (30 days to cure failure); Mich. Comp. Laws § 445.1527 (30 days to cure failure); Wash. Rev. Code § 19.100.180(j) (30 days).

41. See Fine, supra note 38, at 550 ("Inherent abuses in a franchise relationship because of the unequal bargaining powers of large franchisors and individual franchisees").


43. See id. § 482E-6(2)(C).


chisee's exclusive territory; require the franchisee to release any person from liability; obtain undisclosed kickbacks; or unreasonably require a franchisee to submit to a covenant not to compete.

Relief under these laws is most commonly sought by franchisees desiring to enjoin a franchisor’s activities, and relief may also include a damage award. The greatest impact of substantive franchise laws, however, is on the registration process, as most state franchise administrators will register a franchise offering only after the agreement and offering circular have been modified to conform to the state's substantive franchise laws.


Like franchise laws, business opportunity laws require pertinent information to be furnished at designated times prior to the sale of a business opportunity. Most of the statutes permit business opportunity sellers to use the same format of disclosure required by franchise laws. In most cases, the business opportunity seller is also required either to file or register the offering circular prior to offering a business opportunity for sale. Unlike franchise laws, business opportunity laws may require a seller to obtain a surety bond or establish a trust account prior to offering business opportunities for sale. In some states, the amount of the bond or trust account can

47. See Hawai'i Rev. Stat. § 482E-6(2)(E).
49. See id. § 23-2-2.7-1(4).
50. See id. § 23-2-2.7-1(9).
51. E.g., to enjoin a termination, nonrenewal, or refusal to consent to a transfer.
53. See Zeidman, Ausbrook & Lowell, supra note 2, at A-64 to A-68 (various states' requirements as to content of the offering circular and franchise agreement).
54. See generally notes 32-37 and accompanying text.
55. Generally, the process of filing or registering a business opportunity offering is less difficult than registering a franchise offering. See Zeidman, Ausbrook & Lowell, supra note 2, at A-61 to A-64 (procedure for complying with the business opportunity laws).
56. The requirement that sellers obtain a surety bond or trust account in favor of purchasers is the most costly feature of the business opportunity laws. Although some states limit this feature in certain situations in which the seller represents that the initial payment is secured, other states require the surety bond or trust account regardless of the seller's representations. Id. at A-82. See Cal. Civ. Code § 1812.204(c); Ky. Rev. Stat. § 367.815(2); Me. Rev. Stat. Ann. tit. 32, § 4695; Neb. Rev. Stat. § 59-1728.
be so excessive as to preclude the sale of business opportunities.\textsuperscript{57}

Business opportunity laws often contain provisions comparable to those in franchise laws which make certain representations and practices unlawful. For example, it is unlawful to misrepresent certain information and to engage in any false, fraudulent, misleading, or deceptive act.\textsuperscript{58} The business opportunity laws go further by proscribing numerous practices relating to the sale of goods to business opportunity purchasers.\textsuperscript{59} Some statutes, for example, make it illegal to accept money for goods which will not be delivered within two weeks,\textsuperscript{60} require a down payment on goods which exceeds twenty percent of the purchase price,\textsuperscript{61} or fail to deliver goods in a timely manner.\textsuperscript{62}

Sanctions available under business opportunity laws are similar to those under the franchise laws.\textsuperscript{63} However, business opportunity laws often require that the seller furnish the purchaser with a period of time following execution of the contract within which to cancel.\textsuperscript{64} They may also, under certain circumstances, grant the purchaser the right to void the contract up to one year from the date of its execution and receive a refund upon doing so.\textsuperscript{65}

\textsuperscript{57} See, e.g., Cal. CIV. Code § 1812.214(a)(4) (the lesser of $300,000 or the total amount of initial payments from all of the previous year’s business opportunity sales); Ga. Code Ann. § 10-1-412(a) (at least $75,000); Me. Rev. Stat. Ann. tit. 32, § 4695 (at least $30,000); Ohio Rev. Code Ann. § 1334.04(C) (not less than $10,000 at any time); Tex. Rev. Civ. Stat. Ann. art. 5069-16.14 (at least $25,000).

\textsuperscript{58} See Zeidman, Ausbrook & Lowell, supra note 2, at A-78, A-83 to A-84.

\textsuperscript{59} See id. at A-83, A-84. In contrast, the prohibitions imposed by the franchise statutes are more general in nature.

\textsuperscript{60} See id. at A-78.


\textsuperscript{63} See supra note 21.

\textsuperscript{64} See, e.g., Cal. CIV. Code § 1812.209(b) (3 days); Iowa Code § 523B.6 (3 days); Ky. Rev. Stat. § 367.819(1); Me. Rev. Stat. Ann. § 36-4698 (3 days); Neb. Rev. Stat. § 59-1743 (3 days); Ohio Rev. Code Ann. § 1334.05 (5 days); Wash. Rev. Code § 19.110.110(4)(d) (7 days).

III. THE SCOPE OF COVERAGE

Legislatures have defined "franchise" and "business opportunity" to encompass those business distribution relationships in which one party, the franchisee or business opportunity purchaser, is in need of additional protection under the law.\(^6\) The legislatures have identified several key elements which comprise the definitional sections of the statutes. The statutes exempt certain relationships where the legislature has determined that disclosure is unnecessary or does not make sense.\(^7\)

As legislatures differ on which relationships to regulate, which key elements define a relationship, and which relationships should be exempt, there is a resultant lack of uniformity among the statutes. It is quite possible to have a relationship subject to the FTC Rule but not to state franchise and business opportunity statutes, covered by one state franchise or business opportunity law but not by others, or exempt from one state law but not from others. The task of determining coverage under the laws is formidable, owing not only to this statutory maze but also to the large body of regulations, advisory opinions, and informal administrative practices used to interpret these statutory provisions.\(^8\) While some companies may choose to weave their way through this intricate network of federal and state laws, many simply assume that their transactions will be subject to the relevant statutes.\(^9\)

It is not feasible to provide here a thorough analysis of all provisions of the various franchise and business opportunity laws, including related regulations, advisory opinions, and informal administrative practices. A general overview, however, is helpful in determining whether coverage may be likely.

A. FTC RULE

1. Product and Package Franchises

A product franchise is one in which the franchisee distributes goods produced by the franchisor or under the franchisor’s control

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\(^7\) See, e.g., Hawaii Rev. Stat. § 482E-4(a)(6) (sale of second franchise to existing franchisee exempt from disclosure requirements); id. at § 482E.4(a)(5) (renewals and extensions of existing franchise agreements exempt).

\(^8\) See Zeidman, Ausbrook & Lowell, supra note 2, at A-85.

\(^9\) Generally, the task of complying with several statutory provisions is not much greater than complying with a single law, since many of the requirements
or direction, or which bear the franchisor’s trademark. In a package franchise, the franchisee adopts the business format and trademark used by the franchisor. The FTC has determined that product and package franchises have three common characteristics. If all three characteristics are present, the relationship is covered by the FTC Rule.

The first necessary element is the use of a trademark. This involves the distribution of goods or services associated with the franchisor’s trademark. Any use through which the franchisee attempts to gain the benefit of the franchisor’s reputation will satisfy this element. For example, if the goods sold by the franchisee are to bear the franchisor’s mark, or if the franchisee will operate under a name which includes the franchisor’s trademark, the first element will be present in the relationship.

The second requirement is that of significant control or assistance. This will be met if the franchisor increases the franchisee’s chances for success, either by exercising considerable control over the franchisee’s method of operation or by giving the franchisee substantial assistance in his method of operation. The control or assistance may relate to several areas: promotional activities, mar-

(i.e., disclosure) are similar.

See supra notes 32-37 and accompanying text.

70. See Final Guides, supra note 5, at 49,966; Statement of Basis and Purpose, supra note 6, at 59,697-98. See also supra text accompanying notes 6-10 (typical examples of a product franchise).

71. See Final Guides, supra note 5, at 49,966; Statement of Basis and Purpose, supra note 6, at 59,697. See supra text accompanying note 4 (typical package franchises).

72. 16 C.F.R. § 436.2(a)(1)(i)(A)(I). See also Final Guides, supra note 5, at 49,966:

The most common instances occur when either the goods or services being distributed by the franchisee are associated with the franchisor’s mark or when (i) the franchisee must conform to quality standards established by the franchisor with respect to the goods or services being distributed, and (ii) the franchisee operates under a name that includes, in whole or in part, the franchisor’s mark.

Id.

73. See Zeidman, Ausbrook & Lowell, supra note 2, at A-5.

74. See Final Guides, supra note 5, at 49,966. The FTC has expressly indicated that the Rule is inapplicable where no trademark is involved: “The Commission does not intend to cover package or product franchises in which no mark is involved. If a mark is not necessary to a particular distribution arrangement, the supplier may avoid coverage under the rule by expressly prohibiting the use of its mark by the distributor.” Id.

75. 16 C.F.R. § 436.2(a)(1)(i)(B)(I), (2). See also Zeidman, Ausbrook & Lowell, supra note 2, at A-6.

The Commission’s staff recognizes significance as a “function of the degree of reliance which franchisees are reasonably likely to place upon the franchisor’s controls or assistance. Obviously, . . . reliance is likely
marketing plans, organization form, production techniques, inventory requirements, hours of operation, business premises (including location or design), training, and management (personnel or accounting) policies. In some cases, one of these activities may be so prevalent that others need not be present to satisfy the control or assistance element.

Certain activities do not constitute "significant control or assistance" so as to trigger application of the FTC Rule. Specifically, the FTC excludes: protection of the franchisor's trademark, compliance with health and/or safety regulations, distribution of trading stamps in retail sales, credit cards and services; and financing assistance. The third component of a franchise under the FTC Rule is the payment or commitment to pay a sum of money to the franchisor or a designated affiliate. The required amount is at least $500, and must be paid or committed by the franchisee prior to or within the initial six months of operation. The payments may be required either by contract or as a matter of practical necessity.

to be greater in circumstances where the franchisee is relatively inexperienced in the business represented by the franchisor, or where the relative financial risk assumed by the franchisee in relation to its total business is greater [i.e., adding a new product line which is intended to account for a substantial amount of the business' future sales or income compared to a modest amount], or where controls or promised assistance are unique to one specific franchisor as opposed to typical industry practices employed by all businesses in the same industry.''

Final Guides, supra note 5, at 49,967.

76. See 16 C.F.R. § 436.2(a)(1)(i)(B)(1), (2). It should be noted, in considering "significance assistance," that the Rule qualifies the franchisor's contribution in the area of promotion activities, stating: "[A]ssistance in the franchisee's promotional activities shall not, in the absence of assistance in other areas of the franchisee's method of operation, constitute significant assistance . . . ." Id. § 436.2(a)(1)(i)(B)(2).

The Final Guides provide further insight:

The Commission will not interpret a supplier's assistance in a franchisee's promotional activities as "significant," in the absence of additional forms of assistance. This includes assistance in furnishing a distributor with point-of-sale advertising displays, sales kits, product samples and other promotional materials intended to assist the distributor in making sales. It also includes assistance in connection with advertising in the media, whether provided solely by the franchisor or on a cooperative basis with its franchisees.

Final Guides, supra note 5, at 49,967.

77. See Final Guides, supra note 5, at 49,967.

78. Id.

79. 16 C.F.R. § 436.2(a)(2).

80. See Final Guides, supra note 5, at 49,967. The Commission contemplates that this payment will include all sources of revenue which must be paid to the franchisor for the right to market the franchisor's goods and/or services. Id.

81. See id. Such payments are not limited to those specified in the franchise
Although prevalent in many distributorships and dealerships, one category of payments is excepted from the payment requirement. Because the FTC has been unable to determine whether payments for inventory items are made at the franchisee's option or as a matter of practical necessity, payments for "reasonable amounts" of merchandise purchased for resale at bona fide wholesale prices are excluded from coverage under the FTC Rule. However, if the franchisee is required to purchase more than a reasonable quantity of such items, or items in addition to those which qualify for the bona fide wholesale price exception, the relationship will nonetheless fall within the FTC Rule.

2. Business Opportunity Ventures

Business opportunities, as well as franchises, are also covered by the FTC Rule. A business opportunity will be subject to the FTC Rule if it includes three characteristics. The first is that of supplied goods or services. This element is satisfied if the distributor or dealer sells goods or services furnished by the seller or an affiliate, or by a supplier with whom the distributor/dealer is required to do business.

The second element of the FTC Rule is assistance in acquiring agreements but may include concomitant real estate lease payments. Required payments may include initial fees, continuing royalties, and rents or security deposits. They may also be for goods and services such as advertising or bookkeeping assistance, training, promotional literature, and equipment and supplies, including those from third parties where the franchisor or its affiliate receives payments as a result of such purchases. "Practical necessity" payments, for example, include remuneration for equipment which can only be obtained from the franchisor. Id.

82. See id. Reasonable amounts "mean amounts not in excess of those which a reasonable businessman normally would purchase by way of a starting inventory or supply or to maintain a going inventory or supply." Id.

83. See id. at 49,967.

84. See, e.g., Snap-on Tools Corp., Bus. Franchise Guide (CCH) ¶ 6388 (Aug. 27, 1979) (inventory obtained at bona fide wholesale prices if contractual provisions for repurchase of dealer's inventory at his cost or some greater amount effectively makes dealer's inventory investment risk-free); Schwinn Bicycle Co., Bus. Franchise Guide (CCH) ¶ 6381 (Aug. 3, 1979) (bicycles purchased at wholesale prices in quantities specified by dealer within exception).

85. See Final Guides, supra note 5, at 49,967.

86. 16 C.F.R. § 436.2(a)(1)(ii). See Final Guides, supra note 5, at 49,968; Statement of Basis and Purpose, supra note 6, at 59,706.


88. See id. § 436.2(a)(1)(ii)(A)(J)-(3). The franchisor's mere suggestion that the franchisee do business with a particular third party supplier is not enough to meet this requirement. The franchisor must actually require the franchisee to purchase from a specified third party. See ZEIDMAN, AUSBROOK & LOWELL, supra note 5, at A-9.
a location for the dealer or distributor.\textsuperscript{89} Such assistance is present if the seller secures retail outlets or accounts for the goods or services to be sold by the distributor/dealer.\textsuperscript{90} It is also met if the seller obtains sites for devices which dispense goods, such as vending machines or rack displays.\textsuperscript{91} Finally, location assistance is given by the seller if he provides the services of a third person to secure outlets, accounts, locations, or sites.\textsuperscript{92} This last form of assistance will fall within the FTC Rule even if the seller merely introduces the distributor/dealer to the third person or provides the distributor/dealer with a list of such persons.\textsuperscript{93}

The final element is that of a required payment by the distributor/dealer to the seller.\textsuperscript{94} This element is identical to the required payment which will bring a franchise relationship under the coverage of the FTC Rule; thus that prior discussion is equally applicable here.\textsuperscript{95}

\textbf{B. State Franchise Regulation/Disclosure Laws}

Several states have enacted statutes requiring registration prior to the offer, and disclosure prior to the sale, of a franchise.\textsuperscript{96} These states have adopted either the “marketing plan or system” definition or the “community of interest” definition to determine the existence of a franchise.

1. Marketing Plan or System

Nine states employ the “marketing plan or system” definition
of a franchise. 97 Like the FTC Rule, 98 this definition has three requirements, all of which must be present for a franchise to exist and thus come within the coverage of the statutes.

The first of these is the trademark element. The franchisee’s business must be “substantially associated” with the franchisor’s trademark. 99 It will generally be necessary for the franchisor’s trademark to be used as or as part of the franchisee’s business name. 100 However, the element may be satisfied if the use of the franchisor’s trademark on the franchisee’s business premises or on the products sold by the franchisee contributes substantially to the success of the franchisee’s business. 101

The second characteristic, from which this definition derives its name, is a marketing plan or system. It is present if the franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing system prescribed in substantial part by a franchisor. 102 Essentially, the franchisor must provide direction to the franchisee, either initially or on a continuing basis. 103 The determination of whether the guidance provided is sufficient to invoke the statute is made upon consideration of both the magnitude of direction by the franchisor and the number and type of practices of the franchised business for which a system is prescribed. 104


98. Se supra notes 72-81 and accompanying text.

99. California was the first state to adopt this definition. Its definition has since been utilized by states defining a franchise under the market plan or system. The California statute provides as follows:

“Franchise” means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

The operation of the franchisee’s business pursuant to such plan or system is substantially associated with the franchisor’s trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate . . . .


100. Se Zeidman, Ausbrook & Lowell, supra note 5, at A-37.

101. Se id.

102. The California statute is again illustrative: “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 . . . .” Cal. Corp. Code § 31005(a).


104. Se id. at A-34.
Thus, element by element or agreement will result in purchase or royalty, or some other criteria. The payment will also be deemed made if there are payments for equipment, inventory, real estate, or services. Even an agreement to meet a minimum purchase or sales quota may satisfy this element, as may payments to third parties for required inventory purchases.

Some states have adopted variations on the marketing plan or system definition which result in coverage of a greater number of relationships than the general definition. For example, a franchise will exist in New York under either of the following circumstances: (1) the trademark element is present and a franchise fee is paid, or (2) there is a prescribed marketing plan or system accompanied by the payment of a franchise fee. In Virginia only the trademark element and the marketing plan or system element must be satisfied. Thus, a franchise exists under the Virginia statute even if payment of a franchise fee is not required.

2. Community of Interest Definition

Another definition used to determine the existence of a franchise considers the community of interest between the franchisor and franchisee. This definition also has three characteristics which must be present for the relationship to constitute a franchise.

105. See id. at A-41, A-42.
106. See id. at A-42.
107. See id.
109. Id. § 681.3(a).

Typical of the community of interest definition is that found in the Minnesota statute:

"Franchise" means a contract or agreement, either express or implied, whether oral or written, for a definite or indefinite period, between two or more persons:

(a) By which a franchisee is granted the right to engage in the business of offering or distributing goods or services using the franchisor's trade name, trademark, service mark, logotype, advertising, or other commercial symbol or related characteristics;
(b) In which the franchisor and franchisee have a community of in-
First, there is the trademark element. Unlike other definitions which include this element, the community of interest definition requires only that the franchisee "use" the franchisor's mark. Thus, this characteristic will be present regardless of whether the franchisee operates under a logo which includes the franchisor's mark, displays the trademark on the franchised premises (e.g., on a decal), or sells goods bearing the trademark. The second necessary characteristic is that of a common financial interest between the franchisor and franchisee. An ordinary seller-buyer relationship will suffice if the parties believe that the relationship will be a continual one. The final element involves the payment of a franchise fee to the franchisor, as in the market system or plan definition.

C. State Substantive Franchise Laws

Several states have enacted statutes which control the substantive aspects of the franchise relationship, rather than regulate the offer and sale of franchises. Coverage of such statutes may be determined by reference to the definitional sections of the statutes.

Four states employ the community of interest test to determine whether a franchise will be subject to regulation. Each requires a "community of interest" between the franchisor and franchisee in the marketing of goods or services for a franchise to exist. Miss...
sissippi, Nebraska, and New Jersey additionally require a written agreement between the parties and a license from the franchisor to the franchisee to use the franchisor's trademark.\textsuperscript{119} Wisconsin permits the franchisor to elect to grant the franchisee the right to use its trademark or the right to sell specified goods or services.\textsuperscript{120} Other states define a franchise according to the marketing plan or system test.\textsuperscript{121}

A few states have unique definitions of franchises which have sweeping coverage of product and/or service distribution relationships. For example, the Arkansas law applies whenever a person licenses another to either use a trademark or distribute goods or services in an exclusive territory.\textsuperscript{122} Delaware's law is equally broad; remedies are available to any purchaser of trademarked products who resells those products to retail outlets.\textsuperscript{123} Similarly, the Florida

120. Wis. Stat. § 135.02(2).
122. Ark. Stat. Ann. § 70-808(a) provides as follows:
   "Franchise" means a written or oral agreement for a definite or indefinite period, in which a person grants to another person a license to use a trade name, trademark, service mark or related characteristic within an exclusive territory, or to sell or distribute goods or services, within an exclusive territory, at wholesale, retail, by lease agreement or otherwise. Provided, a franchise is not created by a lease, license or concession granted by a retailer to sell goods or furnish services on or from premises which are occupied by the retailer-grantor primarily for its own merchandising activities.
123. Del. Code Ann. tit. 6, § 2551(1) provides in pertinent part:
   (1) "Franchised distributor" means an individual, partnership, corporation, or unincorporated association with a place of business within the State, and engaged in the business of:
   (a) Purchasing or taking on consignment products which bear the trademark or trade name of the manufacturer, producer or publisher for the primary purpose of selling such products to retail outlets; or
   (b) Selling in or through retail outlets products which bear the trademark or trade name of no more than 3 manufacturers, producers, publishers, trademark licensors, or trade name licensors; or
   (c) Purchasing or taking on consignment, books, magazines, journals, newspapers, or other publications for the primary purpose of selling such publications to retail outlets.
   (d) Operating a service station, filling station, store, garage or other place of business for the sale of motor fuel for delivery into the service tank or tanks of any vehicle propelled by an internal combustion engine.
124. Fla. Stat. § 817.416(b) provides:
law generally applies to commercial relationships in which a person is granted the right to offer, sell, or distribute goods which are either manufactured, processed, or distributed by another person.\textsuperscript{124}

Most of the state franchise laws have a bona fide wholesale price exception.\textsuperscript{125} In some states, this exception is broader than that the FTC Rule in that it applies not only to inventory items but also to equipment, real estate, and services as well.\textsuperscript{126} In a few states, however, it is narrower because an additional showing must be made. In these states, a franchisor proposing to rely on the exception must demonstrate that there is a "well-established market" in which the franchisee can resell the goods.\textsuperscript{127} This showing is required to support the theory behind the exception—that a purchaser takes no risk in purchasing goods at bona fide wholesale prices because he can readily resell the goods in the marketplace and thereby recoup at least his initial investment.\textsuperscript{128}

D. State Business Opportunity Laws

Twenty-one states have statutes regulating the offer and sale of business opportunities.\textsuperscript{129} Most of the statutes require an offer, sale, or lease of goods or services to a purchaser.\textsuperscript{130} In most states, the

(b) The term "franchise of distributorship" means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons:

1. Wherein a commercial relationship of definite duration or continuing indefinite duration is involved;

2. Wherein one party, hereinafter called the "franchisee," is granted the right to offer, sell, and distribute goods or services manufactured, processed, distributed or, in the case of services, organized and directed by another party;

3. Wherein the franchisee as an independent business constitutes a component of franchiser's distribution system; and

4. Wherein the operation of the franchisee's business franchise is substantially reliant on franchisers for the basic supply of goods.

\textsuperscript{125} CAL. CORP. CODE § 31011(a); HAWAII REV. STAT. § 482E-2; ILL. REV. ANN. ch. 121 1/2, § 703(14)(c); IND. CODE § 23-2-2.5-1(i)(3); MD. ANN. CODE ART. 56, § 345(\textsuperscript{j})(1); MICH. COMP. LAWS § 445.1503(1)(a); MINN. STAT. § 80C.01(9)(a); N.Y. GEN. BUS. LAW § 681(7)(a); N.D. CENT. CODE § 51-19-02(6)(a); R.I. GEN. LAWS § 19-28-3(j)(1); S.D. CODIFIED LAWS ANN. § 37-5A-4(1); WASH. REV. CODE § 19.100.010(11)(a); WIS. STAT. § 553.03(5m)(a).

\textsuperscript{126} See, e.g., MD. ADMIN. CODE tit. 02, § 02.02.10.01E (1978) (equipment, real estate, services); WIS. ADMIN. CODE § 31.01(9) (1980) (services).


\textsuperscript{128} See ZEIDMAN, AUSBROOK & LOWELL, supra note 2, at A-44.

\textsuperscript{129} See supra note 29.

\textsuperscript{130} See, e.g., CAL. CIV. CODE § 1812.201(a) ("any sale or lease or offer to
goods or services must be purchased to begin a business;\(^1\)\(^3\)\(^1\) in others, they can be used in an existing business.\(^1\)\(^3\)\(^2\) The majority of statutes require an initial payment of a minimal amount, generally ranging from $50 to $500, for the goods or services.\(^1\)\(^3\)\(^3\)

The statutes also ordinarily require the seller to make certain representations to the purchaser. These generally concern the following matters: guarantees of income;\(^1\)\(^3\)\(^4\) refund of the initial investment;\(^1\)\(^3\)\(^5\) repurchase of goods originally supplied by the seller;\(^1\)\(^3\)\(^6\) purchases of items produced (i.e., manufactured or grown) by the seller;\(^1\)\(^3\)\(^7\) the provision of retail outlets or accounts for the sale of goods or services;\(^1\)\(^3\)\(^8\) and provision of locations for vending machines or display racks.\(^1\)\(^3\)\(^9\) The exemptions available under the business opportunity laws vary from state to state. Many statutes, however, contain exemptions for companies which offer and sell franchises.\(^1\)\(^4\)\(^0\) For example, some laws exempt relationships covered by the state’s franchise laws or by the FTC Rule from compliance with the stat-

\(^1\)\(^3\)\(^1\) See generally Zeidman, Ausbrook & Lowell, supra note 2, at A-79 to A-81.
ute. Others exempt companies which offer marketing programs in concert with a registered trademark.

Exemptions other than those afforded to franchisors also exist. Several states have exemptions for sales of business opportunities to “experienced buyers” (i.e., prior customers) or by “experienced sellers” (i.e., sellers who have been in business for at least five years), sellers with large net worths, and sellers with a substantial number of existing purchasers. Exemptions also exist for relationships in specific industries, such as real estate brokers, news paper distributors, and petroleum marketing. Employer-employee relationships and memberships in cooperative associations are also exempt in some states. Finally, a number of states exempt sales of ongoing businesses and sales of securities covered by blue sky statutes.


145. “Not less than 5,000,000; or, not less than 1,000,000 if the seller is at least eighty percent owned by a company with a net worth of not less than 5,000,000.” Zeidman, Ausbrook & Lowell, supra note 2, at A-80 & n.977.

146. “At least twenty-five who have conducted business at all times during the preceding five years.” Id. at A-80 & n.978.


III. Conclusion

All agreements drafted for the distribution of goods or services should be analyzed under both the "franchise" and "business opportunity" laws. The task can be made manageable by considering, in addition to the FTC Rule, coverage under only those state laws which may be applicable to the contemplated transactions.

If it is determined that coverage exists, compliance with the applicable laws may require preparation of an offering circular and revision of the distribution agreement to comply with certain substantive requirements. Compliance may also indicate that registration with state authorities is necessary; that advertising and promotional literature must be approved prior to use; that salespersons must be registered; that a surety bond must be obtained, or trust account established; and that certain sales practices and "pitches" be tailored to comply with the laws.

The applicable statutes create an intricate maze which is especially difficult to navigate without knowledge of the administrative policies and practices of state and federal franchise administrators, and without familiarity with the many interpretive opinions and releases (some of which are unpublished) in this area. The consequences of failing to negotiate the maze, or even to recognize that the statutes apply and thus must be taken into account, can be most serious.