YOU DON'T WANT TO BE A FRANCHISE?
STRUCTURING BUSINESS SYSTEMS NOT TO QUALIFY AS FRANCHISES

Ann Hurwitz
Baker Botts L.L.P.

David W. Oppenheim
Kaufmann Gildin Robbins & Oppenheim LLP

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### TABLE OF CONTENTS

| I.       | INTRODUCTION ........................................................................................................... 1 |
| II.      | WHAT IS A FRANCHISE?...................................................................................................... 1 |
| A.       | FTC Definition of a Franchise ............................................................................. 2 |
| B.       | State Definitions .................................................................................................... 3 |
| C.       | Interpretation of Elements of a Franchise Under Federal and State Law ............. 3 |
| 1.       | Right to Use the Trademark ............................................................................. 3 |
| 2.       | Significant Control, Marketing Plan/Community of Interest............................. 6 |
| a.       | Guidance from the FTC - Significant Control ............................................. 6 |
| b.       | State Advisories and Court Decisions – Marketing Plan/Community of Interest.... 8 |
| i.       | "Marketing Plan" Element .......... 8 |
| ii.      | "Community of Interest" Element .... 10 |
| 3.       | The Franchise Fee or Required Payment .......................................................... 11 |
| D.       | The "Accidental" Franchise ................................................................................ 12 |
| E.       | Key Exemptions Under Federal and/or State Laws .............................................. 13 |
| 1.       | Large Investment Exemption ............................................................................ 13 |
| 2.       | Sophisticated Franchisee Exemption ............................................................. 14 |
| 3.       | Fractional Franchise ....................................................................................... 14 |
| 4.       | Minimum Payment Exemption ............................................................................ 15 |
| 5.       | Leased Departments ........................................................................................... 15 |
| 6.       | Single Trademark License Exclusion ............................................................... 15 |
| III.     | ALTERNATIVE BUSINESS STRUCTURES ...................................................................... 17 |
| A.       | Licenses ............................................................................................................ 17 |
| 1.       | Types of Licenses ............................................................................................... 17 |
| 2.       | The Licensing Model .......................................................................................... 17 |
3. Pros and Cons of Licensing Arrangements .................................................. 18
   a. Advantages of a Licensing Model .......................................................... 18
   b. Disadvantages of a Licensing Model .................................................... 18
4. The License as a "Franchise" ......................................................................... 18
   a. FTC Guidance Regarding Substantial Control ...................................... 18
   b. Case Law Regarding Control/Prescribed Marketing Plan/Community of Interest ......................................................... 19
5. Best Practices ............................................................................................ 22
B. Distributorships .......................................................................................... 22
   1. Types of Distributorships ...................................................................... 23
   2. The Distributorship Model ..................................................................... 23
   3. Pros and Cons of Distributorship Arrangements .................................... 24
      a. Advantages of a Distributorship Model ........................................... 24
      b. Disadvantages of a Distributorship Model ....................................... 25
   4. The Distributorship as a "Franchise" ....................................................... 28
      a. Federal and State Franchise Sales Laws ........................................... 28
      b. State Franchise Relationship Laws .................................................. 30
   5. Best Practices ........................................................................................ 33
C. Joint Ventures .................................................................................................. 34
   1. Types of Joint Venture Arrangements .................................................... 34
   2. Joint Venture Model ............................................................................... 34
   3. Pros and Cons of Joint Venture Arrangements ........................................ 35
      a. Advantages of a Joint Venture Model ............................................... 35
      b. Disadvantages of Joint Ventures ..................................................... 35
   4. The Joint Venture as a "Franchise" .......................................................... 36
      a. Satisfaction of the Definitional Elements ......................................... 36
      b. Exemptions and Exclusions ............................................................ 40
IV. Best Practices ............................................................................................................ 42

D. Sales Representatives ............................................................................................ 42

1. Types of Sales Representatives ........................................................................ 42
2. The Sales Representative Model ..................................................................... 43

3. Pros and Cons of Sales Representative Arrangements ................................ 43
   a. Advantages of a Sales Representative Model ......................................... 43
   b. Disadvantages of a Sales Representative Model ..................................... 44

4. The Sales Representative as a "Franchise" ..................................................... 45
   a. FTC Guidance Regarding Substantial Control ..................................... 46
   b. Relevant Case Law .................................................................................. 46

5. Best Practices ..................................................................................................... 48
   a. No Initial Franchise Fee ......................................................................... 48
   b. Limited Controls Over the Business Operations .................................. 48
   c. Limited Obligations Imposed on the Sales Representative .................. 49
   d. Protection Against Claim for Vicarious Liability .................................. 49
   e. Key Acknowledgements ........................................................................ 49
   f. Avoid Certain Contractual Language ...................................................... 49

E. Exemption-Based Franchising ............................................................................ 49

IV. CONCLUSION ........................................................................................................... 50
I. INTRODUCTION

The franchise model is appealing to businesses, primarily because it affords them the opportunity to experience rapid growth without a substantial investment of capital. Simply put, a franchise company can expand using other people's money and franchising allows the franchisor to spread some of the risk associated with the direct operation of the business. For that reason, franchising is an attractive business model. However, because franchising is a heavily regulated area, there is a substantial cost to franchising. In order to avoid the reach of franchise laws, companies may seek to structure their distribution or licensing programs so that they do not fall within the scope of federal and state franchise laws, thus avoiding the regulatory hurdles that most franchisors face.

In addition, there are a number of industries where the franchise model simply does not make sense because the business owner can be more profitable using another distribution model and has no need to exercise the types of controls or provide the level of assistance typical in franchising. But even where an alternative distribution model is appropriate, the breadth of the franchise laws may pose risks.

In this paper we examine various alternatives to the franchise model. Like franchising, in each of these alternative structures the business owner (or supplier) uses third parties to distribute its goods or services. While there are numerous options when considering alternatives to franchising, in this paper, the authors will address licensing, distributorships, joint ventures, sales representatives and exemption-based franchise programs.

II. WHAT IS A FRANCHISE?

In order to understand how to structure a business to not qualify as a "franchise," it is critical to first understand "what is a franchise" under federal law and numerous state franchise registration, disclosure and relationship laws, each of which is discussed below.

Franchising is heavily regulated both at the federal and state levels. The Federal Trade Commission ("FTC") enacted the FTC Rule in 1979 ("Original FTC Rule") and it was revised substantially in 2007 when the FTC released what is now referred to as the amended "FTC Rule" (the "FTC Rule"). In addition, fifteen states have franchise registration/disclosure statutes, twenty-three states have franchise relationship laws and twenty-six states have franchise registration laws.

1 The authors would like to acknowledge and thank Felicia N. Soler, associate attorney with Kaufmann Gildin Robbins & Oppenheim LLP, and Paul Russell, associate attorney with Baker Botts, L.L.P. for their contribution to this paper.


4 ALASKA STAT. § 45.45.700 et seq. (2011); Arkansas Franchise Practices Act, ARK. CODE ANN. § 4-72-201 et seq. (2011); California Franchise Relations Act, CAL. BUS. & PROF. CODE § 20000 et seq. (2011); CONN. GEN. STAT. § 42-133e et seq.; Delaware Franchise Security Law, DEL. CODE ANN. tit. 6, § 2551 et seq. (2011); Hawaii Franchise Rights
enacted business opportunity statutes which may also affect the sale of franchises or other business opportunities. Therefore, it is critical for any business which engages in licensing and/or distribution activities to understand the elements of a "franchise" as defined under the FTC Rule and state laws. Otherwise, that business' activities may fall within the embrace of such laws, rendering the business an "unwitting" franchisor or "business opportunity" subject to governmental attack, the plethora of criminal and civil penalties which apply to illegal franchising and private rights of action commenced by "franchisees" unhappy with their business relationships.

A. FTC Definition of a Franchise

Under the FTC Rule, a "franchise" is defined as:

[a]ny 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: (1) the franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark; (2) the franchisor 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.\(^6\)

**B. State Definitions**

Although state franchise laws seek to define the term "franchise" by reflecting franchising's underlying economic realities, franchise-regulating states have agreed upon no single, uniform definition and, thus, the scope of coverage of each state statute must be carefully and independently analyzed.

Most state franchise registration/disclosure statutes consider a franchise to exist whenever a franchisee, in return for a franchise fee, is granted the right to sell goods or services under a marketing plan or system prescribed in substantial part by the franchisor, if the operation of the franchisee's business pursuant to that marketing plan or system is substantially associated with the franchisor's trademark, service mark or other commercial symbol. The trademark and fee elements of these statutes mirror the FTC Rule, but the "marketing plan or system" element replaces the FTC Rule's "significant control or assistance" element.\(^7\)

A minority of state franchise disclosure laws apply a slightly different standard when defining the term "franchise." They consider a franchise to exist whenever a franchisee, in return for a franchise fee, is granted the right to sell goods or services using the franchisor's trademark, service mark or other commercial symbol if the franchisor and franchisee have a community of interest in the marketing of such goods or services. These minority states thus substitute the "community of interest" test for the majority's "prescribed marketing plan or system" test.\(^8\)

New York's Franchise Sales Act\(^9\) defines a "franchise" broader than any other state law. In sharp contrast to that employed by every other jurisdiction, where all three elements set forth above - trademark, marketing plan (or community of interest) and franchise fee - must be present for a franchise to exist, in New York, either of the first two elements combined with the franchise fee component will suffice.\(^10\) This broader definition covers many species of licenses, distributorships and other commercial relationships not otherwise subject to franchise laws and regulations. As a result, many businesses are considered franchises under New York law even if they are not in any other franchise-regulating jurisdiction.

**C. Interpretation of Elements of a Franchise Under Federal and State Law**

1. **Right to Use the Trademark**

   The first element – the right to operate a business or sell goods identified or associated (or substantially associated under some state laws) with the franchisor's trademark – is seemingly straightforward. However, contrary to what may be considered a plain meaning

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\(^7\) California, Illinois, Indiana, Maryland, Michigan, New York, North Dakota, Oregon, South Dakota, Rhode Island, Virginia, Washington and Wisconsin follow this approach. See note 3, supra.

\(^8\) Hawaii, Minnesota, Mississippi, Missouri, Nebraska, New Jersey and Wisconsin follow this approach. See notes 3 and 4, supra.


\(^10\) Id. at § 681(3).
interpretation of this element, simply selling a trademarked product does not necessarily mean that the seller has the right to sell goods that are substantially associated with that trademark.

For example, in *Gabana Gulf Distribution, Ltd. v. GAP International Sales, Inc.*, a non-exclusive distributor of GAP brand clothing sued the clothing manufacturer claiming that it was a "franchisee" under the California Franchise Relations Act. Affirming the lower court's decision in favor of the manufacturer, the court noted that the plaintiff was merely a distributor or wholesaler of the apparel maker's products, and was not operating a business substantially associated with the manufacturer's trademarks. The court relied on the plain language in the parties' agreement, which expressly forbade the distributor from "adopt[ing] any trademark, service mark, trade name, trade dress or any element thereof" which could be considered to carry the risk of association with the manufacturer. Additionally, the distributor was expressly prohibited from using the manufacturer's trademark on its business cards, stationary, or in any other way without prior written approval.

Likewise, the plaintiff-distributor in *Southern States Cooperative, Inc. v. Global AG Associates, Inc.* sought protection as a franchisee of the defendant-manufacturer, this time under the New Jersey Franchise Practices Act. The distributor was a non-exclusive retailer of "off-the-shelf" products and also sold products competitive with the manufacturer's products. The distributor operated under its own trade name and required its employees to wear uniforms bearing its own logo. Furthermore, although the manufacturer provided the distributor with sample advertising materials, the distributor could choose to use or not use those materials at its sole option and was never required to participate in any of the manufacturer's advertising campaigns. The court ultimately held that there was no license of the licensor's trademark and that, as a result, the New Jersey Franchise Practices Act was inapplicable. Instead, the court determined that the distributor merely used the manufacturer's mark to make sales.

The case of *Hoosier Penn Oil Company v. Ashland Oil Company* illustrates that the element of substantial association with a trademark can be destroyed where a distributor merely sells a trademark product and/or where its business is associated to a greater extent with another, or several other, trademarks. In *Hoosier Penn*, the plaintiff-distributor filed a motion for a temporary restraining order and preliminary injunction preventing its termination, alleging that the distributor agreement it entered into with the defendant was a "franchise" under Indiana's Deceptive Franchise Practices Act, a franchise "relationship law" which prohibits termination of a franchise without good cause. After the district court ruled that the distributor agreement did not meet the definition of a franchise under the Indiana Deceptive Franchise Practices Act, the plaintiff appealed, arguing that the district court's analysis of the "substantial association" element was flawed. According to the plaintiff, the question for the court should have been whether its business under the defendant's prescribed marketing plan was substantially...

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11 343 F. App'x 258, (9th Cir. 2009).
12 Id. at 259.
13 Id.
14 Id.
16 Id. at 3-7.
17 934 F.2d 882 (7th Cir. 1991).
18 Id. at 884.
associated with the defendant's trademarks and not whether its entire business was substantively associated with the defendant's trade indicia.\textsuperscript{19}

The court of appeals swiftly rejected this argument, noting that it would defy both the explicit statutory language and common sense to ask merely whether the defendant's logo was used when the plaintiff sold the defendant's products. Of course the sales of defendant's products would be associated with the defendant's trademark. Instead, according to the Appellate Court, the proper analysis focused on the plaintiff's business as a whole. Notably, the defendant's logo was not always used in the plaintiff's business correspondence; only one of nine of plaintiff's delivery trucks bore the defendant's logo; and, more importantly, the plaintiff sold twenty other brands of motor oil in competition with the defendant's brand, and had similar distributor agreements with eight to ten of those competitors. Only ten percent of the plaintiff's overall sales volume was attributable to the sale of the defendant's products. For all of these reasons, the court of appeals upheld the district court, and sided that the plaintiff's business was not substantially associated with the defendant's trademarks.\textsuperscript{20}

Numerous other courts have also held that association is not \textit{substantial} where the putative franchisee's business is associated to a greater extent with another trademark. For example, in \textit{B & E Juices, Inc. v. Energy Brands, Inc.},\textsuperscript{21} the plaintiff-beverage distributor argued that it was entitled to protection as a franchisee under the Connecticut Franchise Act. "Substantial association with a franchisor's trademark" is a definitional element under the Connecticut Franchise Act. In order to determine whether the distributor was substantially associated with the defendant-manufacturer's trademarks, the court considered what the result for the distributor would be if it lost its association with the manufacturer. According to the court, termination of the distributor and manufacturer's relationship would not be fatal to the distributor's business since it had a significant number of other beverages to distribute to its customers.\textsuperscript{22} Indeed, the court noted that the majority of the distributor's trucks and coolers bore the marks of its featured brand, Snapple, and that it considered itself a "Snapple House." Therefore, while the distributor was in fact associated with the trademarks of the defendant, it was associated to a far greater extent with the trademarks of a competing manufacturer's brand. Thus, the court held that the distributor's business was not "substantially associated" with the trademarks of the manufacturer.\textsuperscript{23}

In yet another case interpreting the Connecticut Franchise Act, \textit{Terex Corp. v. Cubex, Ltd.},\textsuperscript{24} the court also determined that the "substantially associated" element was not satisfied under Connecticut law which, as discussed above, requires exclusive or nearly exclusive association with a trademark. In \textit{Terex}, the court noted that the plaintiff (who sought protection under Connecticut law) sold more than $6.38 billion in goods the year before, with the defendant's goods accounting for only 0.125 percent of total sales.\textsuperscript{25} Based on these facts, the

\textsuperscript{19} Id. at 885.
\textsuperscript{20} Id. at 886.
\textsuperscript{22} Id. at 13-14.
\textsuperscript{23} Id.
\textsuperscript{25} Id. at 8.
court determined there was no substantial likelihood that the plaintiff would succeed on its claim under Connecticut law since the "substantially associated" standard could not be met.26

2. Significant Control, Marketing Plan/Community of Interest

The second element of a "franchise" requires franchisor control over the franchisee's method of operations or the imposition of a prescribed marketing plan or a community of interest between the parties. Whether or not these elements are satisfied often involves a detailed analysis of the parties' relationship and the outcome is generally determined on a case-by-case basis.

a. Guidance from the FTC – Significant Control

The FTC's Franchise Rule Compliance Guide (the "Compliance Guide")27 explains that the term "significant control" relates to the degree to which the franchisee is dependent upon the franchisor's superior business expertise—an expertise made available to the franchisee by virtue of its association with the franchisor.28 The franchisor may provide its expertise to the franchisee either by exercising control over the franchisee's method of operation or by furnishing assistance to the franchisee in areas relating to the franchisee's method of operation.29 Included among those types of significant controls over the franchisee's method of operation which will satisfy this definitional element are "a) site approval for unestablished businesses, b) site design or appearance requirements, c) hours of operation, d) production techniques, e) accounting practices, f) personnel policies and practices, g) promotional campaigns requiring franchisee participation or financial contribution, h) restrictions on customers, and i) location or sales area restrictions."30 Included among those types of significant promises of assistance to the franchisee's method of operation are "a) formal sales, repair or business training programs, b) establishing accounting systems, c) furnishing management, marketing or personnel advice, d) selecting site locations, and e) furnishing a detailed operating manual."31

Notably, the Compliance Guide states that, as a matter of policy, the FTC will not deem as "significant" control or assistance "trademark controls designed solely to protect the trademark owner's legal ownership rights in the mark under state or federal trademark laws (such as display of the mark or right of inspection)."32 Providing additional clarification on what distinguishes quality control for purposes of protecting trademark ownership under the Lanham Act from the significant control element in the FTC Rule's definition of a "franchise," the Statement of Basis and Purpose issued with the Original FTC Rule (the "Original SBP") provided as follows:

26 Id.
28 Id. at 2-4.
29 Id.
30 Id.
31 Id.
32 Id. at 14.
The trademark licensor is interested in the quality of the final goods produced by the licensees, not in the licensee's method of operation. The kind of control he exercises is thus likely to be limited to "passive" control such as inspection of produced goods and testing to insure that quality standards are being met. Package franchising, on the other hand, involves active control over the franchisee's 'method of operation': the location of the business, the hours of operation, the management of the business, and other business matters.33

In the following Advisory Opinions,34 the FTC Staff responded in the affirmative to inquiries regarding whether the inquirer's proposed business model would establish the "significant control and assistance" element under the FTC Rule.

In Advisory Opinion 04-4,35 the FTC Staff responded to a request for an opinion from a company that had formed a network to compete with established regional and national auto glass networks which dominate the insurance segment of the auto glass replacement market. Auto glass retailers that wanted to join the network would pay membership and other fees and comply with certain system standards in return for their receipt of benefits, including the ability to expand their markets and to perform work for consumers whose insurance claims would be processed through the network. The company asserted that the network would only impose certain quality standards and would not exercise control over its members' business operations.

In determining that the business model satisfied the "significant control and assistance" element, the Staff focused first on the company's control over, and assistance to, the network's members. With respect to controls, the network's members would be required to: be accredited by an independent agency; meet all procedures concerning adhesives; provide a materials and workmanship warranty to their customers; use only new glass in replacing windshields; repair rather than replace windshields whenever possible; have a fixed location; carry minimum insurance; comply with all laws and regulations; be open certain minimum hours; and retain certain records. With respect to assistance, the company would provide the network's members with promotional assistance and with assistance processing insurance claims.

Next, the Staff sought to determine the degree of reliance the network's members were reasonably likely to place upon the company's control and assistance. Although the network's members would most likely be established auto glass retailers with familiarity in the industry, the Staff determined that they would be likely to place great reliance on the company in order to expand the market for their services. They would, according to the Staff, rely on the network's expertise and reputation to gain access to the insurance market, a market that would otherwise be unavailable to them. For these reasons, the Staff determined that the franchised business model met the definitional elements of a franchise under the FTC Rule.

In Advisory Opinion 01-1,36 the FTC Staff responded to an inquiry from a company that sought to share its industry and management expertise with respect to the recruitment and placement of information technology professionals with what they referred to as "strategic

34 The FTC Staff issued more than 100 informal Staff Advisory Opinions under the Original FTC Rule, but since the amendment of the Rule it has issued only two informal Staff Advisory Opinions through 2010.
partners," for each of whom a new limited liability company would be formed. The company would contribute all of the start-up capital, and the company and the strategic partner would split profits, losses and voting rights in proportion to their ownership interest in the limited liability company. Additionally, each strategic partner would be required to enter into a contract with the company or one of the company’s affiliates for what the company described as “back office services.”

The services that would be provided by the company were described as follows:

We provide financial and administrative services designed to help you maximize your earnings potential without compromising your independence.... We strive to provide you with a constantly growing package of benefits, as well as the information and tools necessary to be successful in a rapidly changing world.... With our combined purchasing power, we reduce your costs of operations while enhancing critical benefits including group medical insurance, dental insurance, and pension/401-K programs. We also administer all of your expense accounts and provide you with all the business insurance coverage clients require. With a simple phone call or e-mail our partners have access to management with over 180 collective years of contracting experience to help them with strategic on the job tactical business situations.

In the Staff’s opinion, however, the described services far exceeded what it considered to be “back office services” and, in fact, constituted “significant assistance” under the FTC Rule. Although the Staff acknowledged that “significance” is a function of how much potential franchisees are reasonably likely to rely upon the potential franchisor’s controls or assistance, it did not specifically analyze whether the strategic partners would or would not reasonably rely on the significant assistance provided by the company.

b. State Advisories and Court Decisions – Marketing Plan/Community of Interest

i. “Marketing Plan” Element

The meaning of the phrase “marketing plan or system prescribed in substantial part by the franchisor” has been the subject of much confusion and debate. Indeed, not all state franchise laws define the concept of a marketing plan or system in their statutes. “Instead, most interpretations are found in regulations, interpretive releases, advisory opinions, and judicial decisions.” Notably, a number of states -- including California, Illinois, Maryland and Wisconsin -- feature regulations that, translating statutory definitions, find a prescribed marketing plan or system to exist if a franchisor merely suggests that its franchisees follow an operating program or standard operating procedures.

By far the most elaborate and useful examination of what constitutes a “marketing plan or system” is found in Release Number 3-F Revised (June 22, 1994) (“Release 3-F”) issued 37 John R.F. Baer, David A. Beyer and Scott P. Weber, When are Sales Representatives Also Franchisees?, 27 FRANCHISE L. J. 151, 153 (2008).

38 Id.

by the California Department of Corporations to provide interpretative guidance concerning the
definition of a "franchise" under the California Franchise Investment Law. Careful attention
should be paid to the principles enunciated in Release 3-F and described below, because
franchise administrators and courts of other jurisdictions frequently cite this Release when
analyzing whether the definitional elements of a franchise have been met.

While any one of the following restrictions may not amount to "a marketing plan or
system prescribed in substantial part by a franchisor," Release 3-F states several such
restrictions taken together may be sufficient to amount to such a plan or system: prescribing or
limiting resale prices; restrictions on use of advertising or mail order business; giving detailed
directions and advice concerning operating techniques; assigning an exclusive territory;
providing uniformity or distinctiveness of appearance; limiting the sale of competitive products;
limiting the use of products; requiring approval of advertising and signs; prohibiting engaging in
other activities; providing training sessions; use of an operations manual; and providing "trade
secrets."

*Hillegas v. V.B.C., Inc.*

involved the question of whether a business arrangement was
a "franchise" under the Connecticut Franchise Act. The plaintiff in that case was the exclusive
distributor of the bakery products produced by the defendant. The court determined that the
defendant had exercised sufficient control over the plaintiff so that the relationship between
them constituted a franchise under the Connecticut Franchise Act because the defendant
controlled prices for the bread products and billing to retailers, had sole discretion in changing
product lines and packaging, and trained the plaintiff and his route drivers.

However, in *Dittman & Greer, Inc. v. Chromalox, Inc.*, the court found that an
arrangement between a manufacturer who supplied its electronic heat and control products to
an exclusive seller was not a "franchise" under the Connecticut Franchise Act. The court's
determination turned largely on whether the exclusive seller operated under a "marketing plan"
substantially prescribed by the manufacturer. Factors considered in identifying a "marketing
plan," according to the court, were: "whether the franchisor controlled the hours and days of
operation, advertising, lighting, employee uniforms, prices, trading stamps, hiring, sales quotas,
and management training, as well as whether the franchisor provided financial support to the
franchisee, audited its books, or inspected its premises."

Reviewing the facts before it, the *Chromalox* court noted that the manufacturer did not
make hiring suggestions, recommend sales promotions, assist in closing sales, control prices,
or impose extensive training requirements. Instead, the exclusive seller identified its own sales
targets and the parties cooperated in developing a marketing strategy. The only indicia of a
marketing plan was the requirement that the exclusive seller maintain inventory levels "sufficient
to serve local sales needs," provide an inventory report and comply with limited training
requirements. These factors were not, according to the court, "strongly indicative" of a
marketing plan.

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41 Id. at 5.
43 Id., at 4-5.
44 Id.
ii.  "Community of Interest" Element

The definition of a "community of interest" can be extremely broad. However, the community of interest element is generally found where there is any common or mutual financial interest, however small. Examples of a community of interest include: grant of an exclusive area and sale of goods and services at bona fide wholesale prices; receipt of confidential operating manuals, forms, and mutual opportunity for profit; grant of exclusive territory, covenant not to compete, and training program; required purchases from the franchisor, exclusive territory, franchisor-supplied advertising and leads, and prohibitions on selling competitive products; and, performance of franchisor-devised services, use of franchisor-approved forms, and franchisor approval of all franchisee presentations.45

In Ziegler Co. v. Rexnord, Inc.,46 the Wisconsin Supreme Court identified ten factors to consider when determining whether the "community of interest element" has been met. According to the Court, these factors include, without limitation:

[H]ow long the parties have dealt with each other; the extent and nature of the obligations imposed on the parties in the contract or agreement between them; what percentage of time or revenue the alleged dealer devotes to the alleged grantor's products or services; what percentage of the gross proceeds or profits the alleged dealer derives from the alleged grantor's products or services; the extent and nature of the alleged grantor's grant of territory to the alleged dealer; the extent and nature of the alleged dealer's uses of the alleged grantor's proprietary marks (such as trademarks or logos); the extent and nature of the alleged dealer's financial investment in inventory, facilities, and goodwill of the alleged dealership; the personnel which the alleged dealer devotes to the alleged dealership; how much the alleged dealer spends on advertising or promotional expenditures for the alleged grantor's products or services; the extent and nature of any supplemental services provided by the alleged dealer to consumers of the alleged grantor's products or services.47

In one Wisconsin case, Brio Corp. v. Meccano S.N.,48 plaintiff, the exclusive U.S. distributor of a certain brand of toy, sued defendant, the manufacturer of that brand of toy, for violations of the Wisconsin Fair Dealership Law ("WFDL"). Defendant moved for summary judgment. The outcome of the motion turned on whether the parties' agreement established a "dealership," allowing plaintiff to seek certain protections under the WFDL.49

According to the court, the parties' agreement would be a "dealership" under the WFDL if it granted to plaintiff "the right to sell or distribute goods . . . in which there [was] a community of interest in the business of offering, selling or distributing goods." 50 "Community of interest"

45 Baer, et al., supra note 37, at 154.
46 407 N.W.2d 873 (Wis. 1987).
47 Id. at 879–80.
48 690 F. Supp. 2d 731 (E.D. Wis. 2010).
49 Id. at 739.
50 Id. at 740.
was defined as "a continuing financial interest between the grantor and grantee in either the operation of the dealership business or the marketing of such goods." A "community of interest" would exist if (i) the parties shared a continuing financial interest and (ii) the parties shared interdependence. Although, as discussed above, Wisconsin courts consider ten factors in determining whether there is a shared financial interest and interdependence, the court noted that the basic inquiry is whether the dealer has "a stake in the relationship large enough to make the grantor's power to terminate, cancel, or not renew a threat to its economic health."52

The court noted that the factors weighing against the existence of a "community of interest" were that the relationship between the parties was relatively short in duration and plaintiff had limited use of defendant's proprietary marks on the other hand, the court pointed out that the factors in favor of finding a "community of interest" were that plaintiff was defendant's exclusive U.S. distributor and that plaintiff was required to maintain a certain level of inventory of defendant's toys and meet sales quotas. Ultimately, the court determined that genuine issues of material fact existed so that summary judgment was not appropriate. According to the court, the factual issues included whether plaintiff devoted significant enough portions of its time, funds and/or personnel in selling and advertising defendant's toys, investing in inventory of defendant's toys, promoting defendant's brand and providing supplementary services to defendant's consumers.53

3. The Franchise Fee or Required Payment

The final definitional element of a franchise under federal and state franchise laws is the requirement that the franchisee pay an initial fee. The FTC Rule defines a "required payment" as "all consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise."54 The FTC Compliance Guide explains that the fee element is to be interpreted very broadly and it is intended to capture any types of consideration that a licensee must pay to a licensor or its affiliate for the right to be associated with the franchisor.55 These payments may include: an initial franchise fee; rent to the franchisor or its affiliates; advertising assistance; promotional literature or training kits; equipment and supplies; required training; escrow and security deposits; administrative fees such as accounting or bookkeeping charges; and continuing royalties.56 Further, equipment charges, including charges for equipment to make the ultimate product (such as coffee or ice cream) would qualify as "required payments" under federal and state franchise laws.

Notably, "required payments" do not include payments for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale or lease.57 In order for the bona fide wholesale price exception to apply, the franchisor must only require the franchisee to purchase inventory in amounts which are reasonable for starting inventory or on-going supply.

51 Id.
52 Id.
53 Id. at 724-744.
54 16 C.F.R. § 436.1(s) (2007).
55 FTC RULE COMPLIANCE GUIDE, supra note 27, at 5.
56 Id.
If a franchisor requires purchases in excess of that amount, those purchases could be deemed to be a required payment or franchise fee.  

The *bona fide* wholesale price exemption is applicable only to the purchase of goods that a franchisee is authorized to distribute. It does not apply to the purchase of raw materials required to manufacture the goods which are ultimately sold to the consumer. For example, an ice cream or yogurt franchisor that sold product mixes which are used by the licensee to manufacture the ice cream or yogurt cannot claim that the sale of such mixes at *bona fide* wholesale prices does not qualify as a franchise fee because there is no market for the product mixes other than the existing franchisees. On the other hand, a licensor that sells finished product to its licensees and sells that product to them at *bona fide* wholesale prices for sale at retail would be able to avail itself of the *bona fide* wholesale price exemption.

D. The “Accidental” Franchise

“If it looks like a duck, walks like a duck, it is a duck.” Any relationship between two parties that meets the elements of a franchise, regardless of the title of the agreement or structure of the relationship, will be deemed to be a franchise. While this paper is designed to discuss ways to structure business systems to avoid franchise laws, counsel must always be aware of the elements of a franchise under federal and state laws and make sure that the relationship does not meet the definitional elements of a franchise, thus subjecting a party to the myriad of franchise laws and regulations that govern pre and post-sale conduct.

If your client’s business activities unwittingly bring it within the embrace of federal and state franchise laws, and you and your client are unaware of this fact, your client’s business is in jeopardy and counsel could find itself defending against a malpractice claim.

It has happened all too often that a company that is not a “franchisor” in the traditional sense has discovered that its way of doing business, its methods of distributing products or services, through licenses, distribution agreements, joint ventures or otherwise, brings it within the extraordinarily broad jurisdictional scope of federal and state franchise laws. Unfortunately, this “discovery” usually takes place in the context of a governmental investigation or prosecution, sometimes accompanied by private lawsuits commenced by putative franchisees unhappy with the business relationship.

The problem is simple. Most business people (and many attorneys) are oblivious of the fact that federal and state franchise laws extend beyond traditional franchisors, such as those...
engaged in the fast food, hotel/motel and convenience store sectors of our economy. They are unaware that franchise laws generally define the terms "franchise" and "franchisor" so broadly as to embrace businesses, business relationships, licenses and distribution methods that seem to have nothing to do with traditional franchising.

Accordingly, it is vital that counsel to any business which either engages in licensing activity and/or distributes products or services through independent third parties analyze state and federal franchise laws and advise its clients of the inherent risks associated with proceeding under a model for the distribution of products or services through a third party without complying with state and federal franchise laws.

E. **Key Exemptions Under Federal and/or State Laws**

Both the FTC and the franchise regulating states acknowledge that there are certain circumstances where even though an arrangement between two parties will meet the definitional elements of a franchise, there is a reduced risk (whether due to the size of the investment, the sophistication of the franchisee or other factors) that the franchisee will need the protections of franchise disclosure and relationship laws. As a result, the FTC and the most franchise regulating states have established a number of exemptions which apply to the pre-sale disclosure obligations required under the FTC Rule and the pre-sale registration (and possibly disclosure) obligations under state laws.\(^\text{60}\)

While a discussion of all available federal and/or state exemptions is beyond the scope of this paper, it is important when structuring a business system to avoid franchise laws to consider available exemptions because if a transaction qualifies for an exemption, counsel should be less concerned about drafting an agreement that meets the definitional elements of a franchise and instead could introduce traditional elements of a franchise such as training, marketing materials and on-going assistance into the license or other type of relationship in order to afford greater protections to the licensor.

In addition to the *bona fide* wholesale price exception (discussed above), the following exemptions ought to be considered:

1. **Large Investment Exemption**

Section 436.8(a)(5) of the FTC Rule exempts from its pre-sale disclosure requirements, a sale of a franchise to an investor where the total initial investment (excluding financing from the franchisor) exceeds $1,000,000 and the franchisee acknowledges in writing that the initial investment will in fact exceed $1,000,000.\(^\text{61}\)

According to the Statement of Basis and Purpose which accompanied the release of the FTC Rule ("New SBP"), "the basis for the large investment exemption is not that 'sophisticated' investors do not need pre-sale disclosure, but that they will demand and obtain material information with which to make an informed investment decision regardless of the application of the Rule."\(^\text{62}\)

The required $1 million "investment" (excluding unimproved land costs and financing from the franchisor or its affiliate) should be calculated by reviewing the prospective franchisee's

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\(^{60}\) For a discussion of exemption based franchise programs, see discussion at Section E, *infra.*

\(^{61}\) 16 C.F.R. § 436.8(a)(5).

initial investment as would be set forth in Item 7 of a Franchise Disclosure Document ("FDD") prepared in accordance with the FTC Rule.\textsuperscript{63}

In addition, the required $1 million investment necessary for a franchisor to take advantage of the FTC Rule's exemption "... need not be limited to a single unit... . A multi-unit franchisee investing the threshold amount (or more) in a number of units is just as sophisticated as another franchisee investing a like amount in a single unit."\textsuperscript{64}

Critically, under the FTC Rule, the value of assets which are the subject of franchise conversion or transfer transactions will count when computing the required threshold.\textsuperscript{65} For example, a hotel franchisee that is changing from one franchised brand to another can take into account the initial investment in the original brand (including all improvements to the property) when determining whether the elements of this exemption have been satisfied.

It is important to note, however, that the application of the $1,000,000 investment exemption is more difficult when the franchisee entity is comprised of multiple investors. In that case, the exemption will apply only if at least one individual in a franchisee investor group qualifies as "sophisticated" by investing at the threshold level.\textsuperscript{66}

2. \textbf{Sophisticated Franchisee Exemption}

In addition to the large investment exemption, the FTC Rule also recognizes an exemption based on the net worth and sophistication of the franchisee, which is frequently referred to as the "sophisticated franchisee exemption" or "large franchisee exemption." This exemption applies to entities (including any parent or affiliates) which have been in business for at least five years and have a net worth of at least $5 million. A large franchisee need not have five years of business experience in franchising or in the industry that the franchisee will enter as a result of the franchise. Five years of business experience in any business will suffice.\textsuperscript{67}

The type of prospective franchisee entities eligible for this exemption include corporations, partnerships, other business entities and individuals. With regard to individuals, the New SBP observes: "Nothing prevents an ‘entity’ under this provision from being an individual, but most individuals who have been in business for at least five years and have generated an individual net worth of at least $5 million are likely to have created a corporation or other formal organization through which to conduct business."\textsuperscript{68}

California, Maryland, South Dakota, and Wisconsin exempt offers and sales of franchises to "sophisticated franchisees" from the registration and disclosure provisions of each state’s law.\textsuperscript{69}

3. \textbf{Fractional Franchise Exemption}

The FTC Rule defines a "fractional franchise as "a franchise relationship that satisfies the following criteria when the relationship is created: (1) franchisee, any of the franchisee’s
current directors or officers, or any current directors or officers of a parent or affiliate, has more
than two years of experience in the same type of business; and (2) parties have a reasonable
basis to anticipate that the sales arising from the relationship will not exceed 20% of the
franchisee’s total dollar volume in sales during the first year of operation."70 “Fractional
franchisees” are exempt from the disclosure requirements of the FTC Franchise Rule.

California, Illinois, Minnesota, New York, South Dakota, and Wisconsin71 also exempt
the offer and sale of “fractional franchises” from the pre-sale registration requirements.

4. **Minimum Payment Exemption**

Section 436.8(1) exempts from the pre-sale disclosure requirements of the FTC Rule
those transactions where the required payments (or promises to make required payments)
made within the first six months of the commencement of operation of the franchise to the
franchisor or its affiliate are less than $500.72 Most state laws also contain a similar exemption.
However, the amount and timing of the minimum payment may differ from the FTC Rule.

5. **Leased Department Exemption**

The FTC Rule defines a "leased department" as "an arrangement whereby a retailer
licenses or otherwise permits a seller to conduct business from the retailer’s location where the
seller purchases no goods, services, or commodities directly or indirectly from the retailer, a
person the retailer requires the seller to do business with, or a retailer-affiliate if the retailer
advises the seller to do business with the affiliate."73 The common example of a “leased
department” is a specially designated section such as a make-up or jewelry counter at a
shopping mall. The space for these types of businesses are typically leased by the mall to a
third party retailer and the mall will typically exercise controls over the retail operation (i.e.,
approval rights for all signage, marketing and products). These relationships are typically
exempt from state and/or federal franchise registration and disclosure laws.

6. **Single Trademark License Exclusion**

The Original FTC Rule contained an exclusion at 16 CFR 436.2(a)(4)(iv) for “single
trademark licenses.” In the Original SBP, the FTC stressed that single-trademark relationships
are not franchises even though they might be perceived as falling within the definition of a
franchise.74 To avoid any confusion, the FTC expressly excluded this relationship from the
Original FTC Rule’s coverage.

As part of the FTC’s effort to streamline the FTC Rule, it deleted the single trademark
license exclusion from the final amended FTC Rule text. Notwithstanding that fact, the single
trademark license exclusion is alive and well. In the New SBP, the FTC explained that the

70 16 C.F.R. §436.1(g).
71 Id. at § 436.2(a)(3)(i); California Franchise Investment Law, CAL. CORP. CODE § 31108 (2011); Illinois Franchise
Disclosure Act, I.L. COMP. STAT. § 705/3; Ind. Code § 23-2-2-5-1(a) (2011); MINN. STAT. § 80C.03(f) (2011); Virginia
Retail Franchising Act, VA. CODE ANN. § 13.1-569 (2011); Wisconsin Franchise Investment Law, WISC. STAT. §
553.22.
73 Id. at §436.1(l).
"proper forum to discuss limits to the definition of the term “franchise” is in [the SBP] and in future Compliance Guides" and that the single trademark license exclusion would be retained as a matter of policy and incorporated by reference in the New SBP itself. The Compliance Guide explains the continuation of the exclusion.

Not surprisingly, the single trademark license exclusion might be found to be particularly useful for a business that does not anticipate growing beyond one single licensee. The FTC allows that business to enter into a license agreement with that one licensee for a single location or multiple locations and still take advantage of the single trademark license exclusion. Moreover, the business may enter into a license agreement with that one licensee for a single location and later enter into additional license agreements for additional locations with the same licensee and still take advantage of the single trademark license exclusion.

A licensor who relies on the single trademark license exclusion to the FTC Rule must still exercise extreme caution. First, despite not being subject to the FTC Rule’s FDD preparation and disclosure requirement, the single license may fall within the parameters of a state registration/disclosure or relationship law. An applicable state registration/disclosure law would impose on the licensor registration and/or disclosure obligations and an applicable state relationship law would impose on the licensor certain rules concerning the licensor’s post-sale activity.

Second, "the licensor should consider the long-term effects on growing its system that may stem from entering into a license arrangement in the early stages of system development." In other words, what will happen to the single licensee, and the licensor’s license agreement with the single licensee, if the licensor ultimately decides to expand its system through franchising? Although a potential approach would be to include provisions in the license agreement that would permit or require the licensee to convert its license agreement to a franchise agreement, the FTC has equated the sale of an option to purchase a franchise to the sale of a franchise—triggering the FTC’s disclosure requirement.

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75 72 Fed. Reg. 15,520, n. 777 (Mar. 30, 2007); Id. at 15,530.

76 The [FTC Rule] continues to exclude the trademark licensing arrangements in which a single licensee is granted the right to use the trademark. This exclusion also includes a ‘one-on-one’ licensing arrangement, i.e., the license of a trademark to a single licensee who manufactures the trademarked goods according to the licensor’s specifications. This arrangement is common, for example, in the clothing industry where trademark owners license the manufacture of textiles. The exclusion also includes ‘collateral product’ licensing, i.e., the practice of licensing a trademark that is well-known in one context (e.g., a soft drink logo) for use in another (e.g., on clothing or decorative items embossed with the soft drink logo). This exclusion also includes licensing agreements entered into in the course of settlement negotiations in trademark infringement litigation, when the licensor grants the ‘infringing’ party a license to use the trademark for a specified period.” FTC RULE COMPLIANCE GUIDE, supra note 27, at 16.


80 Id.
III. ALTERNATIVE BUSINESS STRUCTURES

The following is a discussion of four alternatives — licensing, distributorships, joint ventures and sales agents — to the franchise model, including a description of the types, key characteristics and advantages and disadvantages of each. The use of an exemption-based program is also considered.

A. Licenses

One popular, but troublesome, alternative to the traditional franchise model is a license. Of course it is not uncommon, particularly in certain industries like the hospitality industry, for licensors or franchisors to refer to their agreements as "licenses" and their franchisees as "licensees." The "licenses" referred to in this section are licenses entered into between two parties that do not intend to create a franchise relationship. Of course, the overriding concern is that the "license" will be deemed to be a "franchise" and subject to franchise laws, rules and regulations.

1. Types of Licenses

"The types of intellectual property licensing arrangements which have [been] found to be or could be found to create a business relationship subject to state and federal franchise laws include: software licenses, trademark licenses not associated with a package (business format) or product (distribution of goods) franchise system, trademark licenses associated with a package or product based franchisor but sought to be structured to avoid a business arrangement which would be characterized as a franchise, technology or patent licenses, affiliation agreements . . . and pharmaceutical licenses."81 Each of these licensing arrangements may provide for the license of one or more trademarks, copyrights, patents and/or trade secrets.

2. The Licensing Model

Licensing and franchising are very similar because they each involve "leveraging resources, broadening geographic and product markets, obtaining early entry to the market, increasing market penetration through complementary products, obtaining additional revenue and enhancing reputation."82 However, the hurdles imposed on franchisors by the myriad of federal, state and international laws, rules and regulations governing franchising that may be avoided if an alternative model such as licensing is utilized. Among those hurdles is the fact that there may be substantial costs and time involved in preparing and operating a franchise program that complies with all applicable laws and that complying with those laws generally means that a franchisor must publically disclose information about its business (including financial information) that it would not otherwise have to disclose.

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82 Id.
3. **Pros and Cons of Licensing Arrangements**

   a. **Advantages of a Licensing Model**

   The clear advantage of licensing as opposed to franchising is the avoidance of regulatory issues that franchisors face.\(^{83}\) In addition, under a true licensing arrangement, oversight and supervision of the system and the method of operations is minimal. As a result, a license system may be less costly to administer than a franchise program.

   b. **Disadvantages of a Licensing Model**

   Avoidance of franchise regulations by creating a true license arrangement can be problematic for the brand. Typically, a license will grant the licensee the right to use the name and trademarks of another party in exchange for the payment of a fee. Thus, the only difference between a license and a franchise is the degree to which the licensing party may exercise control over, or assist in, the licensee’s methods of operation. Essentially, in exchange for relief from franchise regulations, licensors cede much control over business operations to licensees. The typical licensor party will not be able to train its licensees, oversee daily operations, designate required hours of operation, approve the hiring of a licensee’s key personnel, make recommendations regarding pricing, or otherwise exercise control over the business that it would otherwise undertake in a franchised business model. Absent these controls, there is a substantial risk that the brand or a product or associated with the brand will become diluted in a licensing program.

4. **The License as a “Franchise”**

   There is an inherent risk that any license agreement will be deemed to be a franchise under federal or state law.\(^{84}\) A license will cross the line and become a franchise when, at the federal level, the licensor exercises too much control over the licensee’s operations or, at the state level, there is a “prescribed marketing plan” or “community of interest.”\(^{85}\)

   a. **FTC Guidance Regarding Substantial Control**

   In Advisory Opinion 05-2\(^{86}\), the FTC Staff considered whether a company that had developed a patent-pending method designed to increase sales of staffing companies would be, under its proposed business arrangement, affecting significant control or assistance over its licensees’ (the staffing companies) business operations. According to the company’s letter, the selected licensees were established companies in the staffing industry whose day-to-day business operations would not be significantly controlled by the company’s training and ongoing support. Such training and ongoing support would consist of a one-day training program

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\(^{83}\) The substantial regulatory requirements that franchisors must comply with under federal franchise pre-sale disclosure laws, state pre-sale franchise registration and disclosure laws, franchise relationship laws and business opportunity laws are discussed in detail in Section I. of this paper.

\(^{84}\) Of course, the risk that the license will be deemed to be a franchise is greater in New York than in most states because under the New York Franchise Act, unlike any other state franchise registration and disclosure law, a franchise will be found where the franchisee pays an initial fee and obtains the right to operate a business under the franchisor’s trademark.

\(^{85}\) See discussion, *supra*, at Section II.C.2.

\(^{86}\) Bus. Franchise Guide (CCH) ¶ 6526 (March 2, 2005).
accompanied by printed materials, advice, encouragement and specialized instruction by telephone, e-mail or web-based announcements.

According to the Staff, the proposed business arrangement did not satisfy the "significant control or assistance" element for two reasons. First, the Staff believed that the company was to provide support services that happened to be tailored to the staffing industry, as opposed to seeking to control or assist its licensees in operating a staffing service business. As such, any controls and assistance would not be over the licensees' entire method of operation. Second, the Staff believed that the licensees would not be likely to place great reliance on the company in the operation of their businesses since licensees would be well-established businesses in the staffing field.

b. Case Law Regarding Control/Prescribed Marketing Plan/Community of Interest

The issue before the court in The National Survival Game of New York, Inc. v. NSG of LI Corp.\(^87\) was whether the defendant-licensee was a franchisee within the New York Franchise Act. The dispute centered around the operation of what is generally known as "Survival Games" - a high-tech version of Cowboys and Indians. The plaintiff originally entered into an agreement with the National Survival Game, Inc., an entity that granted the it the right to operate survival games in the New York metropolitan area, including Long Island. The plaintiff then entered into an agreement with the defendant, granting the defendant the right to operate a survival game on Long Island. The lawsuit stemmed from an alleged breach of that agreement.

In its discussion, the court stated that the credible evidence clearly indicated that New York's requirement of the sale of products or services "under a marketing plan or system prescribed in substantial part by the licensor" was not satisfied. Indeed, the defendant "physically laid out the playing fields, established the nature and rules of the games played, used his own knowledge and experience acquired during military service, purchased equipment for the conduct of the games from suppliers other than [the plaintiff] [sic] and in general ran his business as he saw fit rather than under a marketing plan or system prescribed by [the plaintiff]."\(^88\)

The plaintiff in Leonetti Furniture Manufacturing Co. v. Sealy, Inc., and The Ohio Mattress Co.\(^89\) was a furniture manufacturer and, until shortly before the beginning of this action, a licensee of the defendant. The defendant was one of the leading manufacturers of mattresses and box springs in the United States and owned several federal registrations for the familiar "SEALY" trademark. The plaintiff sold Sealy products, as well as its own brand of sleeper-sofas. The plaintiff sought a preliminary injunction against the defendant's decision to terminate the plaintiff and the defendant sought a preliminary injunction with respect to its trademark infringement and unfair competition claims.

The vast majority of the plaintiff's memorandum in support of its motion for preliminary injunction was devoted to its claim that the license agreement between the parties could not be terminated because the defendant had violated the FTC Rule and various state franchise rules.


\(^88\) Id. at 3.

by failing to provide the plaintiff with a pre-sale disclosure document. Although the court initially noted that there was no need to consider whether the defendant had violated such regulations and/or statutes since the plaintiff did not state a cause of action under same, the court nonetheless briefly discussed its position that the relationship between the two parties did not constitute a "franchise" under the federal regulations.

With respect to whether the defendant exerted a significant degree of control over the plaintiff's marketing plan or system, the plaintiff pointed to numerous "Covenants" in the parties' contract with regard to, among other things; the plaintiff's use of its best efforts to promote the sale of Sealy products, the maintenance of adequate facilities to manufacture those products, the confidentiality of "trade secrets," and non-infringement of the defendant's trademarks. Additionally, the plaintiff argued that the defendant's right to make routine inspections, discussions with the plaintiff with regard to how plaintiff's salespeople should approach customers, and the fact that the plaintiff manufactured and sold goods with the Sealy trademark constituted a "significant degree of control." 92

The court disagreed. The court held that the defendant did not exert a "significant degree of control" over the plaintiff's operations for the following reasons: the defendant had no control over the hours that the plaintiff remained open; the defendant did not have any control over the "style" of the operation; and the plaintiff had long been in the business of manufacturing and selling its own line of sofabeds, an operation over which it had sole control. The fact that the plaintiff had to manufacture SEALY sleeper-sofas pursuant to the defendant's specifications and standards did not mean that the defendant had a significant degree of control over the plaintiff's operations. 93

Richard Vaughn and Patricia Vaughn v. Digital Message Systems Corp. et. al. 94 considered whether the marketing plan element of the Michigan Franchise Investment law ("MFIL") had been satisfied such that a franchise was created between the parties. The defendant in that case was a company that had developed the "On-Hold Programming: system," a system that provided information to businesses' telephone callers while they were "on hold." The plaintiffs were collectively a licensee that was granted the non-exclusive right to sell or lease the system to local businesses.

Turning to the facts of the case, the court found that the defendant had indeed prescribed in substantial part a marketing plan for the plaintiffs within the meaning of the MFIL. First, the court examined the definition of "prescribe" Under the MFIL. "It can be fairly and reasonably said . . . that an entity 'prescribes' a marketing plan when it articulates guidelines about the sales and marketing of its own product, including the training and recruitment of a sales force, and then recommends in the strongest terms these guidelines as a model for a person or another entity which is selling the product pursuant to a license obtained from it." 96

90 Id. at 10-11.
91 Id. at 11.
92 Id. at 12.
93 Id.
96 Id.
Next, the court turned to the express language of the parties' contract, which gave the defendant the right to approve all promotional and advertising methods and materials used by the plaintiffs and obligated the defendant to provide the plaintiffs with certain "marketing/operating supplies . . ., a training/operating manual, as well as reasonable quantities of selling supplies, brochures, demonstration tapes, supply order/price forms, and such other materials as the [defendant] shall, from time to time make available to its Licensees." The defendant was also obligated to provide the plaintiffs with up-to-date pricing, leasing and warranty information regarding the products being sold. According to the court, "the marketing and informational packages, the training, the sales tips and strategies, the advertising, the recruitment of sales people, and the specified marketing area, all of which Defendants provided to Plaintiffs, as well as the required number of [sic] systems that Plaintiffs were to buy and sell at the risk of contract termination, make it perfectly clear that, under the MFIL and its regulations, Defendants prescribed in substantial part a marketing plan or system for Plaintiffs." 

In Southwestern Adjusting Co., et al. v. Underwriters Adjusting Co., et al., the court determined that a claims adjustment services license was not a "franchise" under New Jersey law, since the licensor and the licensee did not share a "community of interest" in the marketing of the goods and services provided. The plaintiff had premised its claim on the theory that the defendant, as a franchisor, was forbidden from discontinuing the parties' agreements simply because the contract fixed a three-year term without renewal.

The court noted that courts that have considered whether a "community of interest" exists have focused on several factors, including: "(1) licensor's control over the licensee; (2) the licensee's economic dependence on the licensor; (3) disparity in bargaining power; and (4) the presence of a franchise specific investment." With respect to the first element of control, the court noted that the defendant required managers to attend a training program, imposed operations guidelines contained in a written manual and regularly monitored licensees. Notwithstanding those facts, the defendant also left its licensees with room for direction - including the right to use their own marketing efforts, the ability to deal with customers directly; and, permission to do business with non-contract customers even when that business brought the licensee into direct competition with the defendant. Considering these facts, the court determined that the defendant did not subject the plaintiff to a high level of control.

Turning to the second element of economic dependence and the third element of unequal bargaining power, which are interrelated, the court noted that the plaintiff and the other licensees were independent adjustors prior to contracting with the defendant. The defendant encouraged them to maintain their non-contract business during the pendency of the licensing agreement, even when that business brought the licensees in direct competition with the defendant. Essentially, the licensees' history, client base and post-termination survival demonstrated a relatively small degree of dependence on the defendant.

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96 Id. at 8-9.
97 Id.
99 Id at 9-10.
100 Id at 10.
101 Id at 11.
Last, the court turned to the fourth element of a substantial franchise specific investment. Even though the court noted that the investment may be tangible or intangible, it did have to be substantial. Looking at the facts before it, the court determined that, although the defendant's licensees did pay an initial license fee, the plaintiff had not sunk capital or other resources into very specific assets, such as a particular service, a unique product, product name or narrow customer base, that could not have been recouped or transferred to another business venture or investment, as required by the community of interest standard. Since none of the four elements were satisfied, the court could not find that a community of interest existed.102

Finally, the relationship created by a sublicense that gave a manufacturer the right to produce and sell a Dutch company's boilers under the trademarks of the licensor and sublicensor in the United States was not a franchise within the Washington Franchise Investment Protection Act, according to the court in Intermark, Ltd. v. H.B. Smith Co., Inc.; H.B. Smith Co., Inc. v. Sam Scimeca and Jane Doe Scimeca.103 Among other reasons given for its holding was that the sublicensor did not have a significant community of interest in the sublicensee's business, since it had very little control over the manner in which the technology was used. The requirement that the sublicensee maintain a certain level of quality for items bearing the licensed trademarks, as well as the need to obtain the sublicensor's permission before using the trademarks was, in the court's opinion, more relevant to the Lanham Act than to the Washington Franchise Investment Protection Act.

5. Best Practices

Franchise counsel should always caution his or her clients that there is a substantial risk in engaging in pure licensing. A licensor that licenses intellectual property may never be immune to a challenge that its relationship with its licensees is subject to federal or state franchise laws. However, a license agreement which only provides for control necessary to permit the franchisor to protect the trademark owner's rights to the trademark under state and federal trademark laws, such as restrictions regarding the use and display of the trademark, should not fall within the embrace of the franchise disclosure laws.104

B. Distributorships

A distributorship is an arrangement in which one party (the distributor) purchases products or services from another party (the supplier) for resale. The terms "distributorship" and "dealership" are often used interchangeably. Although a distributor is generally understood to be one who resells the products or services it purchases to dealers and other retailers, and a dealer is generally understood to be one who resells the products or services it purchases to the end user,105 distributors and dealers are alike in that they purchase products or services from a supplier with the intention of reselling those products or services at a price higher than the price

102 Id at 12.
104 See FTC RULE COMPLIANCE GUIDE (May 2008), supra note 27, at 5. Counsel must always be mindful of the broad scope of the New York Franchise Act which defines a franchise to include only the payment of a fee plus either requires only either in connection with a marketing plan prescribed by the franchisor or in connection with the distribution of goods substantially associated with the franchisor's trademark.
they paid. Although the terms "distributor" and "distributorship" are used throughout this paper, the discussion also applies to dealers and dealerships.

1. Types of Distributorships

Most distributorships are identified with the sale of particular products, including appliances, cars, liquor, beer and wine, and heavy equipment. Although the existence of service distributorships has been noted, product distribution is particularly well-suited to a distributorship model. A supplier can more easily build its profit into the price of a product, avoiding the need to charge other fees, and the sale of a product (as opposed to the sale of a service) typically requires less control by the supplier.\textsuperscript{106}

2. The Distributorship Model

In a distributorship, the distributor pays the supplier a \textit{bona fide} wholesale price for the supplier's products and then resells the products at a higher price. The terms of distributorship agreements differ. Some distributorships may be exclusive while others are non-exclusive. The distributor may or may not be required to provide ancillary services in connection with its sale of a particular product. In addition to term, termination, indemnification and other standard provisions, most distributorship agreements address certain principal issues.

In order to maximize penetration of the supplier's product line, distributors are assigned territories within which to operate. These territories are often exclusive, particularly where a distributor is obligated to meet annual sales quotas. Given that the purpose of the distributorship arrangement is to move the supplier's products through the distribution chain, distributorship agreements frequently require the distributor not only to use best efforts to promote the sale of the supplier's products in the distributor's territory, but also require the distributor to purchase and sell at least a minimum amount of product annually. The distributor also may be required to maintain certain inventory in stock. Distributorship agreements will typically contemplate some level of training for the distributor in the operation of the supplier's products.

The distributorship agreement will address the price at which the distributor must purchase the product, as well as payment and delivery terms. Pricing is often determined by the supplier's price list in effect at the time of the order, with the supplier retaining the right to change the price list on advance written notice to the distributor. Shipping terms serve to allocate the risk of loss between the supplier and distributor. For suppliers that deal in both the U.S. and international markets, it is important to differentiate between trade terms commonly used in the U.S. under Article 2 of the Uniform Commercial Code\textsuperscript{107} and those developed by the International Chamber of Commerce for use in international trade.\textsuperscript{108} Procedures for the return and replacement of defective products by the distributor will also typically be included in the distributorship agreement, as well as prohibitions against the distributor's modification or reproduction of the product. While multi-line distributors may carry more than one product line, distributors are generally prohibited from carrying product lines that compete directly with the supplier's products.

\textsuperscript{106} McCullough and Baer, supra note 81.

\textsuperscript{107} See, e.g., U.C.C. §§2.103-2.106 (2001).

A distributorship agreement will typically require the distributor to promote the supplier’s product line. The distributor may be required to purchase products for demonstration, to display the supplier’s products on the distributor’s website and/or in catalogs and to otherwise promote the sale of the products. The distributor also serves as an important source of information for the supplier and may be required to report periodically on commonly sold and successful products, and customer demand and requests. The supplier will likely provide a limited warranty for its products which the distributor will be required to pass on to purchasers of the products. Such warranties typically limit the supplier’s liability for damages related to the use and operation of the product. The distributor may serve as the warranty coordinator, receiving warranty claims from customers and submitting them to the supplier. The distributor also may be authorized to perform warranty services.

While the products will likely bear the supplier’s trademark, a distributorship agreement also will typically grant the distributor a royalty-free license to use the supplier’s trademark in connection with the sale and promotion of the supplier’s products in the distributor’s territory. The distributor may also be expressly given the right to identify itself as an authorized distributor of the supplier’s products.

3. **Pros and Cons of Distributorship Arrangements**

   a. **Advantages of a Distributorship Model**

   Just as a franchisor benefits from the financial and human resources provided by its franchisees, in a distributorship model suppliers benefit from the distributors’ financial resources and sales staffing. Distributors also often have deep experience in and particular knowledge about the products they distribute and/or the markets they serve, which enable them to effectively identify customers for the supplier’s product.

   Unlike franchising, in a distributorship model the supplier does not take a portion of the distributor’s gross revenue as a royalty payment. Instead, the supplier makes its money from the sale of its products to the distributor. This removes a source of potential tension from the relationship that is typically a part of the franchise model. In a distributorship model, the distributor purchases the product from the supplier for resale. The distributor, not the supplier, then bears the financial risk of any unsold inventory.

   Also, while distributorship agreements may contemplate some level of training in the operation of the supplier’s product and may impose certain marketing and promotional obligations on the distributor, the level of control found in the distributorship model is generally much less significant than that found in a franchise model. Perhaps in part because the distributor is very often selling a completed product, the supplier does not have the same incentive to control all aspects of the distributor’s operations as might exist in a business format franchise where the sale of such “products” as food, haircuts and lodging is often inextricably entwined with the delivery of a service that reflects on the franchisor’s brand.

   The supplier also may delegate to the distributor post-sale installation and/or servicing obligations. Even if the distributor is paid a commission or other compensation for such services, the ability of the supplier to pass these obligations through to the distributor eliminates the need for the supplier to maintain the personnel required to perform such services.
b. Disadvantages of a Distributorship Model

One of the advantages of the distributorship model may also be perceived as a disadvantage: that is, distributors typically operate more independently than do franchisees, with the supplier having less control over the operation of the distributor’s business than that exercised by a franchisor. The supplier therefore must depend more on the distributor to properly present the supplier’s brand and promote the sale of its products.

Moreover, those business owners who look to a distributorship model as a way to avoid regulation will be disappointed. In addition to industry specific statutes regulating distributorships at the federal and state levels, distributorships also may be subject to general state relationship statutes109 and to federal and state business opportunity laws.110

At the federal level, the Automobile Dealer Franchise Act (“Automobile Dealer Act”)111 and the Petroleum Marketing Practices Act (“PMPA”)112 provide automobile dealers and certain motor fuel distributors, respectively, with some basic protections.

Enacted in 1956, the Automobile Dealer Act permits an automobile dealer to bring suit in federal court against an automobile manufacturer to recover damages (including the cost of the suit) sustained by the dealer by reason of the manufacturer’s failure to act in good faith in performing or complying with the terms of the parties’ franchise or in terminating, canceling or not renewing the dealer’s franchise.113 The term “franchise” is broadly defined114 but the required “good faith” is narrowly defined.115 This narrow definition has prevented dealers from recovering damages for such manufacturer actions as establishing a new dealership in an existing dealer’s market area, awarding a dealership to an existing dealer’s competitor, and refusing to allow a dealer to relocate or transfer its franchise.116 However, the Automobile Dealer Act expressly states that it does not invalidate any state law, except in the event of a direct conflict which cannot be reconciled,117 paving the way for the more protective state automobile dealer legislation described below.

The PMPA applies to franchises for the sale or distribution of motor fuel under a refiner’s trademark.118 The Act lists the permissible grounds for termination or non-renewal of the

109 The term “relationship statute” refers to those laws that regulate various aspects of the parties post-sale contractual relationship, preempting contrary contractual provisions to provide greater protections to those covered by the statute.

110 In addition to the federal and state regulatory schemes discussed in the text, a number of other laws impact the distributorship model, including the Uniform Commercial Code, state “Little FTC Acts” and the antitrust laws. For an excellent discussion of these issues, see McCullough and Baer, supra note 81.


114 The term includes any “written agreement or contract between any automobile manufacturer engaged in commerce and any automobile dealer which purports to fix the legal rights and liabilities of the parties.” McCullough and Baer, supra note 81, at 11.

115 Good faith is the duty “to act in a fair and equitable manner... so as to guarantee... freedom from coercion, intimidation, or threats of coercion or intimidation.” 15 U.S.C. § 1221 (2011).

116 See McCullough and Baer, supra note 81, and the cases cited therein.


118 Costello, et al., supra note 79.
franchise relationship and prohibits any termination or failure to renew that is not based on those grounds and otherwise in compliance with the notification and other requirements of the Act.\textsuperscript{119} The PMPA preempts state laws regulating termination and nonrenewal of a covered franchise unless such provisions are the same as the applicable provisions of the Act.\textsuperscript{120}

Most states have enacted laws protecting distributors that operate in one or more specific industries. These include state statutes that protect motor vehicle dealers. Unlike the Federal Automobile Dealer Act, the state statutes afford motor vehicle dealers significant protection in a number of areas, including termination, cancellation, failure to renew, encroachment, succession and others.\textsuperscript{121} Other state statutes afford protections to distributors of liquor, beer, wine, heavy equipment, farm implements, motorcycles and all terrain vehicles, recreational vehicles and others.\textsuperscript{122} There are wide variations among these state statutes and each must be examined independently.

In addition to the protections afforded distributors by these industry-specific statutes, general state relationship statutes also may apply to the distributorship arrangement, affording the distributor yet another source of protection against certain supplier conduct. These statutes may expressly apply to distributors and dealers\textsuperscript{123} or they may expressly apply to “franchises,” but contain such a broad definition of “franchise” that traditional distributorships and dealerships are also covered.\textsuperscript{124} The statutes govern, among other things, cancellation and non-renewal of the distributorship agreement. The Maryland, Rhode Island and Wisconsin statutes require notice and an opportunity to cure prior to termination, cancellation or non-renewal,\textsuperscript{125} and under the Wisconsin statute, any substantial change in the competitive circumstances of a dealership agreement.\textsuperscript{126} Although the statutes differ, each contains certain exceptions from the

\textsuperscript{121} See, e.g., the Alabama Motor Vehicle Franchise Act, ALA. CODE §§ 8-20-1 to -12 (2011).
\textsuperscript{122} See, e.g., ARK. CODE ANN. §§ 4-72-301 to -309 (imposing certain inventory repurchase requirements on termination of franchised retailers of farm implements, machinery, utility, industrial and other equipment); IOWA CODE §§ 123A.1-123A.12 (2011) (requiring good cause and notice for a brewer’s termination or failure to renew a beer wholesaler); and S.C. CODE ANN. §§ 56-16-10 to -210 (2011) (regulating the relationship between motorcycle manufacturers or distributors and dealers).
\textsuperscript{123} See ALASKA STAT. § 45.45.700 et seq. (2011); Maryland Fair Distributorship Act, Md. CODE ANN., COM. LAW § 11-1301 et seq. (2011); Rhode Island Fair Dealership Act, R.I. GEN. LAWS § 6-50-1 et seq. (2011); Wisconsin Fair Dealership Law, WIS. STAT. § 135.01 et seq. (2011); Puerto Rico Dealers Contracts, P.R. LAWS ANN. tit. 10, § 278 et seq. (2011). The Rhode Island Fair Dealership Act defines as “dealership” as: “A contract or agreement, either expressed or implied, whether oral or written, between two (2) or more persons, by which a person is granted the right to sell or distribute goods or services, or use a trade name, trademark, service mark, logotype, advertising or other commercial symbol, in which there is a community of interest in the business of offering, selling or distributing goods or services at wholesale, retail, by lease, agreement or otherwise. R.I. GEN. LAWS § 6-50-2.(3). The definition of a general “dealership” under the Wisconsin Fair Dealership Law is the same. See WIS. STAT. § 135.02(3)(a). The definitions of “distributor” under the Maryland Fair Distributorship Act and of “dealer’s contract” under the Puerto Rico Dealers Contracts differ, but also are very broad. Md. CODE ANN., COM. LAW § 11-1301(g)(i)-(iv); P.R. LAWS ANN. tit. 10, § 278.(b). Alaska defines a “distributor” as a wholesaler or manufacturer and a “dealer” as a person who enters into a distributorship agreement and who, under the agreement, receives merchandise or services from a distributor. ALASKA STAT. § 45.45.790(1),(2). None require payment of a fee.
\textsuperscript{124} See Section III.B.4.b. for a discussion of the coverage of distributorships under state franchise relationship statutes.
\textsuperscript{125} See Md. CODE ANN., COM. LAW §§ 11-1302.1, 11-1303 (2011); R.I. GEN. LAWS § 6-50-4 (2011); WIS. STAT. § 135.04 (2011).
\textsuperscript{126} WIS. STAT. § 135.04 (2011).
requirements of notice and cure (e.g., bankruptcy, insolvency or voluntary abandonment) and provides for certain repurchase obligations. The Alaska law requires a distributor to repurchase the affected portion of the dealer's business and reimburse the dealer for certain expenses if the distributor terminates the relationship or makes substantial changes in the competitive circumstances.\textsuperscript{127} If either party terminates the agreement, the distributor must, at the dealer's option, repurchase the unused inventory that was purchased by the dealer from the distributor and pay all transportation charges for its return. Puerto Rico's Act 75 prohibits any grantor from performing any act detrimental to the relationship\textsuperscript{128} or refusing to renew except for "just cause," which is defined in the statute as "the nonperformance of any of the essential obligations of the dealer's contract on the part of the dealer or any action or omission on his part that adversely and substantially affects the interests of the grantor in promoting the marketing or distribution of its merchandise or services."\textsuperscript{129} If there is no just cause for termination, for detriment to the existing relationship or for the refusal to renew, the grantor must indemnify the dealer, with the amount of the indemnity determined based on factors set out in the statute.

Both the industry-specific and general relationship laws discussed above provide protections to the distributor after the distributorship agreement has been signed. In some cases, the "sale" of the distributorship arrangement itself may be covered under federal and/or state business opportunity laws. At the federal level, business opportunities are regulated under the FTC's rule governing Disclosure Requirements And Prohibitions Concerning Business Opportunities ("Business Opportunity Rule").\textsuperscript{130} The federal Business Opportunity Rule applies to any continuing commercial relationship in which (i) a person (the business opportunity purchaser) offers, sells or distributes goods or services supplied by the business opportunity seller (or a supplier mandated by or affiliated with the seller), (ii) the seller secures for the purchaser retail outlets or accounts or locations or sites for vending machines, rack displays or other product sales displays (or provides the services of someone able to secure such outlets, accounts, locations or sites), and (iii) the purchaser makes a payment or commitment to pay the seller as a condition of obtaining or commencing the business opportunity.\textsuperscript{131}

While the federal Business Opportunity Rule may be viewed as somewhat restrictive given the requirement that the business opportunity seller must provide or arrange for the provision of retail outlets, accounts, locations or sites, the state business opportunity laws are broader.

Twenty-six states have business opportunity laws.\textsuperscript{132} Although statutory definitions differ, a "business opportunity" is generally an arrangement under which (a) the business opportunity

\textsuperscript{127} \textit{Alaska Stat.} § 45.45.740 (2011).

\textsuperscript{128} Section 278a-1(b) lists four areas in which it is presumed (absent contrary evidence) that a grantor has impaired the existing relationship. These include: direct distribution into Puerto Rico or the appointment there of additional dealers, the grantor's unjustifiable refusal or failure to fill the dealer's orders in reasonable amounts and within a reasonable time, and when the grantor unilaterally and unreasonably varies shipping methods or manner, conditions or terms of payment to the dealer's prejudice. \textit{P.R. Laws Ann. tit. 10, § 278a-1(b)} (2011).

\textsuperscript{129} \textit{P.R. Laws Ann. tit. 10, § 278(d)} (2011).

\textsuperscript{130} 16 C.F.R. § 437 (2007). This Rule is currently in the process of being amended. The proposed new business opportunity rule includes a number of substantive changes, including the deletion of the $500 threshold for required payments and the required disclosure document would be significantly streamlined by requiring only basic information on a short "disclosure form".

\textsuperscript{131} \textit{id.} at §437.2.

\textsuperscript{132} Supra note 5.
purchaser sells goods or services supplied by the business opportunity seller or its affiliate or a required third party supplier; (b) the business opportunity seller makes certain representations to the business opportunity buyer, including that the seller will assist the buyer in securing accounts or locations for vending machines, rack displays, etc., or the seller will repurchase products purchased by the buyer, or the seller will provide a sales or marketing program to the buyer; and (c) the business opportunity buyer is required to pay a minimum fee (generally, $200 to $500) to the seller. Payments made to purchase goods at a bona fide wholesale price are not generally an exception to the fee element of the definition and may therefore satisfy that definitional element. That, combined with facts that suggest a supplier provided or represented that it would provide a sales or marketing program, may result in coverage for certain distributorships.

However, the majority of the state business opportunity laws apply only to arrangements where the seller supplies goods or services used by the purchaser to start a business. If sales are to a distributor with an existing business, particularly one that carries similar product lines, the statutes may not apply. In addition, in a number of states the marketing plan element will not apply if the marketing plan is provided in conjunction with a state or federally registered trademark.

If an arrangement is a "business opportunity" and is not exempt, the business opportunity seller must prepare and provide a disclosure document to prospective business opportunity purchasers within a certain time before the business opportunity contract is signed (at least 10 business days under the current federal rule and at various times under state laws, ranging from 48 hours to 10 business days). Additional requirements under the state business opportunity laws include registration of the business opportunity or a list of business opportunity salespeople, filing of advertising materials, posting a surety bond or depositing a portion of the purchase price in an escrow account, and providing the buyer with a post-sale right to rescind.

4. The Distributorship as a "Franchise"

a. Federal and State Franchise Sales Laws

In order for a distributorship not to be a franchise, at least one of the definitional elements must be eliminated. All are potentially present in a distributorship.

A distributor is given the right to offer, sell or distribute the supplier's products, and the offer, sale and distribution of such products is made in association with the supplier's trademark. This association is frequently enough to satisfy the trademark element of the franchise definition, although the association may not be sufficient in the case of a multi-line distributor

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133 South Carolina is the lone exception, where a "business opportunity" does not include sales of products where the payment is made for product inventory sold to the purchaser at a bona fide wholesale price. Three other states exclude product inventory sold at a bona fide wholesale price, albeit under very limited circumstances. Illinois and South Dakota exclude product inventory sold at a bona fide wholesale price only where the payment does not exceed $500. Oklahoma has a similar exclusion where the payment does not exceed $750.

134 Exceptions are: California, Indiana, Nebraska, and Ohio.

135 They are: Alaska, Connecticut, Florida, Georgia, Illinois, Iowa, Louisiana, Maine, Maryland, Michigan, North Carolina, Oklahoma, South Carolina, South Dakota, and Washington.

136 See Cal. Comm'r Release No. 3-F, supra note 39, which states that the grant of a right to use the franchisor's symbol will satisfy the trademark element of the definition even if the franchisee is not obligated to display the symbol. See also Shelley Spandorf and Mark Kirsch, The Accidental Franchise 9-12, American Bar Association American Bar Association 24th Annual Forum on Franchising (2001) (discussing the breadth of the trademark element).
where one supplier's product line represents a small percentage of the distributor's total business.\textsuperscript{137} Although a supplier in a distributorship arrangement typically does not exercise the same level of control or provide the same degree of assistance as a franchisor, some indicia of control and/or assistance (or evidence of a marketing plan under state law) is likely to exist in all distributorships. Among other things, suppliers may assign territories, provide training, provide or reserve the right to approve marketing materials, and/or suggest pricing. And, as discussed earlier, the control or assistance/marketing plan element of the franchise definition is the most difficult to clearly eliminate.\textsuperscript{138}

This leaves the fee element of the franchise definition.\textsuperscript{139} And it is this aspect of the definition that often distinguishes a true distributorship from a franchise which is subject to federal and state laws requiring disclosure and, at the state level, registration. Arrangements in which a supplier requires its distributor to pay only a \textit{bona fide} wholesale price for goods which the distributor intends to resell should not satisfy the fee element of the franchise definition.

The definition of "required payment" under the FTC Rule states expressly that a required payment does not include payments for the purchase of reasonable amounts of inventory at \textit{bona fide} wholesale prices for resale or lease.\textsuperscript{140} The state franchise registration laws contain similar exceptions.\textsuperscript{141} The rationale for the exception is that "no substantial prejudice will come to a person buying a business and paying only the \textit{bona fide} wholesale price for merchandise which that person proposes to sell in the business."\textsuperscript{142}

There is little guidance on what constitutes a "\textit{bona fide} wholesale price." California defines \textit{"bona fide" wholesale price} as "the price at which goods are purchased and sold by a manufacturer or wholesaler to a wholesaler or dealer where there is ultimately an open and public market in which sales of the goods are effected to consumers of the goods."\textsuperscript{143} Illinois notes that the exception will apply only "if the price charged constitutes a fair payment for goods purchased at a comparable level of distribution."\textsuperscript{144} The determination of \textit{bona fide} wholesale price is a question of fact, with the supplier bearing the burden of proof.

The \textit{bona fide} wholesale price of goods can vary at different levels in the distribution system or based on the quantity of goods sold, and trademarked products may command a

\begin{footnotes}
\item[137] See the cases reviewed at Section II.C.1. of this paper.
\item[138] See the cases reviewed at Section II.C.2. of this paper.
\item[139] Even under New York's broad statutory definition of a franchise, there must be a fee paid either in connection with a marketing plan prescribed by the franchisor or in connection with the distribution of goods substantially associated with the franchisor's trademark. N.Y. GEN. BUS. LAW § 681(3) (2011).
\item[140] 16 C.F.R. §436.1(s) (2007).
\item[141] See, e.g., California Franchise Investment Law, CAL. CORP. CODE §§ 31005(a), 31011(a) (2011); Illinois Franchise Disclosure Act, ILL. COMP. STAT. §§ 705/3(1), 705/3(14) (2011); Virginia Retail Franchising Act, VA. CODE ANN. § 13.1-559 (2011). There is no separate \textit{bona fide} wholesale price exclusion in the Oregon franchise law, but Section 441-325-0030 of the Regulations exempt from disclosure any franchise that is exempt or excluded under 16 C.F.R. §436.8(a), including subsection (1), which exempts arrangements in which the total of the required payments (or commitments to make a required payment) to the franchisor or its affiliate within the first 6 months of beginning operations is less than $500, and the definition of "required payment" excepts out payments for inventory intended for resale at a \textit{bona fide} wholesale price. OR. ADMIN. R. §441-235-0030 (2011).
\item[142] Cal. Comm'r Release No. 3-F, supra note 39.
\item[143] Id.
\end{footnotes}
premium without destroying the *bona fide* wholesale price exception. But, if the sales price is
negotiable, that may defeat the claim of *bona fide* wholesale price since the price will vary
based on the purchaser's negotiating ability. The exception also does not apply to payments for
services (such as training) or for equipment or supplies to be used in the operation of the
business. And, the amount of goods purchased under the exception must be limited to that
which a reasonable business person would buy as start up inventory or to maintain an on-going
supply of inventory.\(^\text{145}\)

The danger, of course, is that a supplier will require its distributors to purchase excess
inventory or charge additional fees, triggering application of the final element of the definition
and converting the "distributorship" to a franchise under the FTC Rule and state registration
laws.

In *US Mac Corporation v. Amoco Oil Company*,\(^\text{146}\) the plaintiff alleged several causes of
action in connection with its contract to distribute Amoco products, including sale of an
unregistered franchise under the California Franchise Investment Law. In refusing to grant
summary judgment on the franchise claim the court observed that it had insufficient evidence to
determine whether the alleged *bona fide* wholesale price charged to the distributor included a
hidden franchise fee. It also noted that the contract gave Amoco the right to specify minimum
delivery quantities and either refuse to make deliveries of less than the minimums or charge
extra for making those smaller deliveries, finding that those provisions could result in a hidden
franchise fee.

A hidden franchise fee was found to be present in *Pool Concepts, Inc. v. Watkins, Inc.*\(^\text{147}\)
In that case, a dealer sought an injunction against the termination of its dealership arguing that it
was entitled to protection under the Minnesota Franchise Act. The critical issue was whether the
dealer was required to pay a franchise fee. The supplier argued that the dealer paid only for the
spas it purchased and that payments were at a *bona fide* wholesale price. The dealer argued
that the payments included an amount which the supplier contributed to a coop advertising fund
and that that amount constituted a hidden franchise fee. Apparently persuaded by a document
in which the supplier based the formula for the coop payment on the dealer's spa purchases,
the court agreed, holding that it "conclusively establishes that the cost of the co-op program is
built into the price of the spa, thereby creating an indirect franchise fee."\(^\text{148}\)

b. **State Franchise Relationship Laws**

As noted above in Section III.B.3.b., some state relationship statutes that nominally
apply to "franchise" relationships define the term "franchise" so broadly that traditional
distributorships may be covered. Under these statutes the term "franchise" is defined without
reference to a fee.\(^\text{149}\) The absence of a franchise fee is therefore not relevant to coverage under
the statute.

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\(^\text{145}\) Cal. Comm'r Release No. 3-F, supra note 39. See also the discussion of the *bona fide* wholesale price exception
at Section II.C.3. of this paper.


\(^\text{148}\) Id. at n. 2.

\(^\text{149}\) For example, Arkansas defines a "franchise" as an oral or written agreement in which a person is granted a
license to use a trade name, trademark, service mark or related characteristic within an exclusive or non-exclusive
territory or to sell or distribute goods or services within such a territory at wholesale, retail, by lease agreement or
In Emergency Accessories and Installation, Inc. v. Whelen Engineering Co., Inc., a manufacturer (Whelen) sought to terminate the Master Distributorship Agreement of Emergency Accessories and Installation, Inc. ("EAI"). EAI challenged the termination, seeking injunctive relief under the New Jersey Franchise Practices Act. The Court applied New Jersey law even though the Master Distributorship Agreement contained a Connecticut choice of law provision, and applying the Act's definition of "franchise" to the parties' relationship, found that the relationship was a covered franchise under the Act.

Under the New Jersey Act, EAI had to show that it maintained a place of business (as defined in the Act) in New Jersey, that Whelen had granted EAI a license, and that there was a "community of interest" between it and Whelen. EAI also had to demonstrate sales of Whelen products in excess of $35,000 in the twelve months preceding the suit and that more than 20% of its gross sales were derived, or were intended to be derived, from the relationship. The Court found that EAI established its likelihood of success on the issue.

EAI maintained a place of business in New Jersey at which it displayed and offered Whelen products for sale and trained technicians on their use. Although the Master Distributorship Agreement did not use the term "license," it did authorize EAI to use Whelen trademarks and trade names associated with the products for the purpose of promoting their sale in accordance with the parties' agreement. The Court interpreted this authorization as the required license. EAI also was likely to prove a community of interest between it and Whelen. It had made franchise-specific investments to market and promote Whelen products and had converted customers from competitors to the Whelen line. The contract required EAI to maintain an inside and outside sales force of adequate size to maximize the sale of Whelen products and to use its best efforts to promote and sell those products. Whelen products comprised approximately 95% of EAI's emergency lighting products and 53% of its entire inventory. In the twelve months prior to suit, EAI had sold $1,931,000 of Whelen products, representing 37% of its total sales.

Hartford Electric Supply v. Allen-Bradley Co was an appeal from a judgment permanently enjoining a manufacturer from terminating its distributor in violation of the Connecticut Franchise Act. On appeal, the manufacturer argued that the trial court improperly found that a franchise relationship existed. The Connecticut Act defines a franchise as an agreement or arrangement that requires the substantial prescription of a marketing plan and substantial association with the franchisor's trademark or commercial symbol.


153 736 A.2d 824 (Conn. 1999).
The appellate court looked to the decision in Consumers Petroleum of Connecticut, Inc. v. Duhan for a list of factors relevant to determining the substantial prescription of a marketing plan under the Connecticut Act. Although not definitive, these include whether the franchisor controls: hours and days of operation, advertising, lighting, employee uniforms, prices, trading stamps, hiring, sales quotas and management training.

It then found that the trial court had properly identified a number of factors in the parties' relationship that supported the franchisor's substantial prescription of a marketing plan or system: (i) the distributor's business plan was subject to the manufacturer's approval, and once approved, became the manufacturer's plan to enforce on the distributor; (ii) the manufacturer possessed power over pricing, instructing the distributor on price quotes and publishing a catalog used by the distributor which listed a manufacturer's suggested price for each item; (iii) while the distributor had the ultimate authority to hire and fire its personnel, the manufacturer exerted some control over personnel decisions, particularly when the distributor had been placed in a remedial sales program, and in fact, the trial court found that the manufacturer used this program to "dictate virtually every aspect of the [distributor's] operations"; (iv) the manufacturer required the distributor's personnel to undergo extensive training on the manufacturer's products; (v) the manufacturer exercised significant control over the distributor's product, monitoring inventory and pressuring the distributor to stock more; and (vi) the manufacturer had the right to examine the distributor's financial records and require audits.

The appellate court next reviewed the trial court's findings on the second element of the definition: substantial association with the franchisor's trademark, trade name or other commercial symbol. Although the manufacturer argued that statute required franchisees to have no separate identity or to be dependent on a single supplier, the appellate court held that argument ignored the plain meaning of the word "substantial" association.

The trial court had found three factors establishing substantial association with the manufacturer's trademark: (i) distribution of the manufacturer's catalogues and promotional materials containing its logos; (ii) the distributor's flyers included the defendant's logo; and (iii) the distributor prominently displayed a sign containing the manufacturer's name on the distributor's premises. Moreover, the court found that for fifty years the distributor had been recognized as a leading distributor of the manufacturer's products, causing people to think of them as "one and the same." In addition, substantial association was shown by the level of dependence that the distributor had on the manufacturer: termination would cost the distributor one-half of its gross annual sales and cause its business to fail.

Where the relationship statute is included within a state's registration law or coexists with a registration statute, the presence of a fee element in the franchise definition may be thought to preclude coverage of traditional distributorships. However, even where a fee is

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156 736 A.2d 824, 834 (Conn. 1999).
157 Id. at 834-36.
158 Id. at 837.
159 Id. at 838.
160 Id. at 839.
161 Id.
162 For a discussion of this point, see Costello, et al., supra note 79.
required as part of the franchise definition, if the dispute involves a relationship issue, a court
may stretch to find that the fee element is satisfied.

The Indiana franchise relationship statute defines those franchises subject to coverage
by reference to the definition of franchise under the Indiana franchise registration law.\(^{163}\) That
law defines a franchise by the three typical definitional elements: a marketing plan or system
prescribed in substantial part by the franchisor; substantial association with the franchisor's
trademark; and payment of a franchise fee.\(^{164}\) Moreover, under the statute, franchise fees do
not include the purchase or agreement to purchase good at a \textit{bona fide} wholesale price.\(^{165}\)

In challenging Ricoh Corporation's refusal to renew its distributorship agreement under
the Indiana relationship law, the distributor (Wright-Moore) admitted that it did not pay a direct
franchise fee.\(^{166}\) Rather, it argued that it paid indirect franchise fees in the form of payments for
training, to maintain excess inventory and for ordinary business expenses.

The trial court refused to grant Ricoh summary judgment and it appealed. On appeal, the
7th Circuit examined each of the alleged indirect franchise fees in light of the reason for the
franchise fee requirement: "to insure that only those entities that have made a firm-specific
investment are protected under the franchise laws."\(^{167}\) With that as guidance, it held that: (i)
excess inventory can constitute an indirect franchise fee if the quantity of product is so
unreasonably large as to be illiquid; (ii) training costs may result in an indirect franchise fee if
highly firm-specific; and (iii) ordinary business expenses can also constitute an indirect franchise
fee if an unrecoverable investment in the franchisor. Because there was conflicting evidence on
these issues, the 7th Circuit concluded that the lower court had properly denied summary
judgment.\(^{168}\)

5. \textbf{Best Practices}

a. Be aware of and avoid any indirect payments that could be
considered hidden franchise fees.

b. Be prepared to explain and support the legitimacy of the supplier's
\textit{bona fide} wholesale price.

c. Be prepared to establish that purchase requirements are
reasonable, do not charge extra for orders below an established minimum, and restrict on-going
purchases to reasonable re-stocking requirements.

d. In addition to industry specific statutes, be aware of the
relationship laws in Alaska, Arkansas, Connecticut, Maryland, Missouri, New Jersey, Rhode
Island, Wisconsin, Puerto Rico and the Virgin Islands, as they may apply to the arrangement.

\(^{163}\) \textit{IND. CODE} \S 23-2-2.7-5 (2011).
\(^{164}\) \textit{IND. CODE} \S 23-2-2.5-1.(a)(1)-(3) (2011).
\(^{165}\) \textit{Id.} at 1(i)(3).
\(^{166}\) \textit{Wright-Moore Corp. v. Ricoh Corp.}, 908 F.2d 128 (7th Cir. 1990).
\(^{167}\) \textit{Id.} at 135.
\(^{168}\) \textit{Id.} at 136.
C. **Joint Ventures**

1. **Types of Joint Venture Arrangements**

A joint venture has been defined as an association of two or more persons to carry on a single business enterprise for profit.\(^{169}\) The joint venture is ordinarily limited to a single business purpose, although it need not be, and that single purpose may take years to complete.\(^{170}\) Joint ventures can be conducted through various types of legal arrangements, including general and limited partnerships, corporations and limited liability companies. Each of those structures has its own set of attributes.

Aside from tax advantages,\(^{171}\) a general partnership structure offers flexibility. But this flexibility is counterbalanced by the unlimited liability of each partner for the acts of other partners as agents of the partnership, as well as vicarious liability for the acts of partnership employees acting within the scope of their employment.\(^{172}\) A limited partnership affords the partners the same tax benefits as a general partnership structure but offers limited liability to each of the "limited partners."\(^{173}\) However, limited partners cannot participate in the management of the partnership without forfeiting that limited liability.\(^{174}\) A corporate structure is well-suited to raising capital and affords the owners the most protection against personal liability, but a corporation is the least advantageous form of entity for tax purposes.\(^{175}\) There are more formalities governing the operation of corporations, profit-sharing is difficult and corporate governance rules are rigid.\(^{176}\) Limited liability companies combine significant tax advantages\(^{177}\) with the benefits of limited liability for the members of the entity. The laws governing limited liability companies also typically allow maximum flexibility in areas like governance, capitalization, allocations and liquidation.\(^{178}\)

2. **Joint Venture Model**

When a joint venture is used as an alternative to franchising, the founder of the business concept becomes one of the joint venture partners. The founder typically brings the business concept to the joint venture, including the trademark that identifies the business and other intellectual property that is important to the operation of the business. The other joint venture partner typically contributes capital and labor.

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\(^{170}\) BLACK'S LAW DICTIONARY 915 (9th ed. 2009).

\(^{171}\) General partners can deduct partnership losses on their individual tax returns and partnerships avoid the double taxation (at the entity level and at the individual level on distribution) present in the use of a C corporation. BRUCE P. ELY AND CHRISTOPHER R. GRISSOM, CHOICE OF ENTITY: LEGAL CONSIDERATIONS OF SELECTION A-8 to -9 (2009).

\(^{172}\) Id.

\(^{173}\) Id. at A-10.

\(^{174}\) Id.

\(^{175}\) Id. at A-15.

\(^{176}\) Id.

\(^{177}\) Id. at A-23.

\(^{178}\) Id. at A-21.
Regardless of the form or forms of entity used to structure the joint venture, in every case there is one basic structuring issue: will the business concept founder and owner of the intellectual property contribute the intellectual property to the joint venture or will it license the intellectual property to the joint venture?

Direct contribution of the intellectual property to the joint venture is often perceived to be unworkable since assignment of the intellectual property to one joint venture entity complicates future expansion with other joint venture entities using the same intellectual property. Therefore, the intellectual property owner will most often license the intellectual property to the joint venture. However, the existence of a license arrangement between the intellectual property owner and the joint venture entity in which the owner participates increases the likelihood that the structure may be deemed to be a franchise since the elements that define a franchise are more likely to be present. See the discussion below at Section III.C.4.

3. Pros and Cons of Joint Venture Arrangements

a. Advantages of a Joint Venture Model

Because the owner of the intellectual property is also an owner in the joint venture entity, it has the potential for an increased economic return from its direct ownership in the business.

Depending on the joint venture structure, the intellectual property owner also has a greater opportunity to directly control the business by virtue of its ownership interest in the venture. This would be the case where the intellectual property owner and its joint venture partner are both general partners and where the intellectual property owner is the general partner in a limited partnership or where it is the majority owner in a corporation or limited liability company. It would not be the case where the intellectual property owner is a limited partner in a limited partnership or the minority owner in a corporation or limited liability company.

Particularly if the intellectual property owner controls a majority interest in the joint venture entity, its control of that entity will make it easier for that entity to adapt quickly to changes in the market. In addition, aside from state statutes governing entity formation and operation and state and federal tax laws, there are no regulations that apply to joint ventures per se.

b. Disadvantages of Joint Ventures

Just as a joint venture owner has the potential for an increased economic return through direct ownership of an interest in the joint venture, it also faces increased financial risk from its direct investment in the business. The use of entities that afford their owners the protections of limited liability can help to reduce that risk.

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179 Andrew L. McIntosh and Kimberley A. Agster, Walking Like A Duck: Joint Ventures and Franchises, 26 Franchise L. J. 85 (2007); Spandorf and Kirsch, supra note 136.
180 Id. at 88.
181 However, if the intellectual property owner licenses the intellectual property to the joint venture, the license agreement gives the intellectual property owner an independent source of control.
182 Although, a joint venture may be subject to regulation as a business opportunity.
Structuring options can also aid in reducing risk. For example, if a joint venture is structured as a general partnership, each of the general partners in the joint venture might be limited liability entities. An intellectual property owner that participates in a joint venture structure might also limit the amount of capital (if any) that it contributes to the joint venture and license its intellectual property to the joint venture rather than contributing it directly. In addition to allowing the intellectual property owner to use the same intellectual property in multiple joint ventures, the license arrangement reduces the risk that the intellectual property will be lost to creditors of the joint venture if the business fails.

Apart from the financial risk, there are other disadvantages of a joint venture structure. Owners in joint venture entities may owe one another certain fiduciary duties. In contrast, franchisors have been found not to owe a fiduciary duty to their franchisees.

It has also been observed that it may be difficult to compel the performance of joint venture partners and to unwind relationships structured as corporations, partnerships and limited liability companies. Additionally, an intellectual property owner that is both an owner in the joint venture and a licensor to the joint venture, may find that it has conflicts of interest in its different roles.

4. The Joint Venture as a “Franchise”

a. Satisfaction of the Definitional Elements

In order to protect its intellectual property from the risk of business failure and to enable it to be used in multiple joint venture arrangements, the intellectual property owner that participates in a joint venture is most likely to license the intellectual property to the joint venture instead of contributing it directly. As noted above, the presence of a license increases the likelihood that the joint venture may be found to be a franchise.

The license includes the grant of a right to engage in the business of offering, selling or distributing the subject good or services in association with the licensed trademark. With little difficulty the trademark licensor can cross the line between exercising permissible trademark controls and the types of control or assistance that would satisfy the requirements for a franchise under the "significant control or assistance" definitional element of federal law and the "marketing plan" or "community of interest" definitional element under state franchise laws. (See the discussion in Section II.A. of this paper.)

The remaining element of the franchise definition is the fee element. That definitional requirement is clearly satisfied if the joint venture pays the trademark licensor a royalty fee. But what if there is no royalty required under the license agreement?

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183 Consider the duties of loyalty and care that partners owe to one another. UNIF. P'SHIP ACT § 404 (rev. 1997).

184 Majority shareholders may owe fiduciary duties to minority shareholders (18A AM.JUR. CORPORATIONS § 1085 ) and members in a limited liability company may owe fiduciary duties to one another (46 AM. JUR. 2D JOINT VENTURES § 2000).

185 McIntosh and Agster, supra note 179, at 89-90.

186 It has been noted that differences between the Original FTC Rule and the FTC Rule as amended in 2007 could affect who is considered to be the franchisee if in fact the joint venture arrangement is determined to be a franchise. See Costello, et al., supra note 79.
Staff Advisory Opinion 98-5\textsuperscript{187} suggests that the lack of a royalty fee will not necessarily result in a finding that no fee exists as long as the trademark owner is entitled to receive a share of the profits from the business.\textsuperscript{188} The opinion was issued in response to a request asking whether the following structure qualified for the minimum payments exemption under the Original FTC Rule. The writer’s client proposed to offer its business system to a number of investors, each of which would form a separate corporation. In each corporation, the investor would be the majority shareholder and the system owner would be the minority shareholder. The system owner would also license each corporation the use of its trademark.

The opinion identifies three types of payments in the proposed structure. Investors were required to purchase equipment and other assets to operate the business, but all such purchases were from independent third parties which the FTC Staff assumed made no indirect payment to the system owner; therefore, they did not constitute a required payment. Investors were required to pay consulting fees to the system owner, but payments were not scheduled to begin until six months after the commencement of operations; the Staff found that those payments appeared to fall within the Rule’s minimum payment exemption. Finally, as a minority shareholder in each corporation, the system owner was entitled to a share of the recurring profits from the business. The Staff opined that these prospective, unspecified payments could constitute a required payment that may not qualify for the minimum payment exemption.

The Staff reasoned that recurring profits derived from an ownership interest in the business differed little from the recurring royalties typically paid by a franchisee to a franchisor: in each case, the system owner received payments for the use of its trademark and other proprietary information. However, the Staff lacked sufficient information to determine whether the payment of profits in this case would constitute a required payment.

To make that determination, the Staff would look to the reasonable expectations of the parties, determined at the time they entered the business arrangement, taking into consideration: (i) the type of industry involved and the prior financial history of the putative franchisor and any existing franchisees; if typical businesses in the industry generated profits of at least $500 during the first six months of operations, it would be reasonable to assume the parties in this case had the same expectation; (ii) the sales price and likely demand for the goods and services offered by the business and the level of royalty or license fee; these factors can indicate the anticipated level of profits that might be expected in the relevant six–month period; and (iii) any representations made by the system owner to the investors; if there were representations made from which the investors could reasonably conclude they would earn sufficient revenues to pay the system owner at least $500 in the first six months, the required payment element would be satisfied.

In addition, Staff Advisory Opinion 01-1\textsuperscript{189} indicates that a fee can be present where the sharing of losses is a condition to the business relationship. As discussed in Section II.C.2.a. of

\textsuperscript{187} FTC Staff Advisory Opinion 98-5, Bus. Franchise Guide (CCH) ¶ 6494 (June 24, 1998). The advisory opinions reflect the opinions of the FTC Staff charged with enforcement of the FTC Rule. They are not reviewed, approved or adopted by the FTC and are not binding on the FTC. Between 1979 and 2006, the FTC Staff issued over 100 advisory opinions. Since 2007, when the FTC Rule was amended, the Staff have issued only 2 advisory opinions, both in 2007.

\textsuperscript{188} But see 1973 Cal. Sec. LEXIS 199 (Feb. 1, 1973), discussed below, and In re Matter of Wallach, 203 N.Y.L.J. 3, at 22 (N.Y. Sup. Ct. Jan. 4, 1990), Bus. Franchise Guide (CCH) ¶9587 (holding that payments to a trademark owner for stock in a brokerage business was not a franchise fee).

\textsuperscript{189} Supra note 36.
this paper, an affiliate ("GHG") of an information technology staffing company was formed to enter into a series of limited liability companies with multiple "strategic partners." GHG would contribute one hundred percent of the start up capital to each limited liability company in exchange for a 75% ownership interest. Each strategic partner would contribute its labor in exchange for a 25% ownership interest. Neither member of the limited liability company would receive a salary; instead, profits would be paid or losses would be allocated to the members at year end in proportion to their respective ownership interests. The request acknowledged that the trademark element of the franchise definition was satisfied by the proposed structure and, as explained previously in Section II.C.2.a., the FTC Staff found that the significant control or assistance element of the definition also was satisfied.

The sole remaining question was whether the fee element of the definition was present. In this case, the Staff concluded that it was not. The strategic partner's contributions of labor did not constitute a required payment under the FTC Rule. Although the strategic partner's agreement to assume a current obligation to share in the losses of the business would constitute a required payment, here the obligation to pay any losses did not occur until more than six months after the business operations began, satisfying the minimum payment exemption. The Staff reasoned that if GHG were then to try to enforce the obligation, the strategic partner could raise defenses of fraud or breach, minimizing any potential injury.

At the state level, various partnership arrangements have been found to be franchises. Two early opinions of the California Commissioner under the California Franchise Investment Law found franchises to exist in arrangements involving a proposed series of general partnerships and a common investment in a corporation operating a chain of clothing stores.

In Commissioner's opinion 79/2F,190 three partners ("Partners") proposed to open several restaurants operating under a common name owned by two of them under a series of general partnership agreements with other individuals ("Operating Partners"). In each partnership, the Partners would hold a 75% interest and the Operating Partner would hold a 25% interest. Each Operating Partner was experienced in the restaurant business, would be responsible for day-to-day operations in the manner prescribed by the majority of the partnership, and would receive a salary and its share of the profits. The Partners would be paid a 1% management fee and each partnership would acquire food, supplies and services from the Partners' affiliate under a supply agreement terminable at will by either party on notice.191

The Commissioner found all three elements of the franchise definition were satisfied; the Partners were the franchisor and each partnership was a franchisee. Each partnership was granted the right to engage in the restaurant business under a common name owned by the Partners. Because the Partners owned a majority interest in each partnership, they could control all essential operational decisions, satisfying the marketing plan element of the definition. The 1% management fee and the supply agreement satisfied the fee element of the definition.192

Commissioner's opinion 4736F193 involved a proposed business arrangement between the trademark owner ("Aca Joe") and the owner of a chain of clothing stores ("Topps"). Aca Joe would contribute its trademark and capital in exchange for stock in Topps and half the net pretax

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191 Id. at 1-3.
192 Id. at 3-4.
profits from the Aca Joe Division of Topps. Topps would sell Aca Joe clothing in its chain of clothing stores. An Executive Committee of the Aca Joe Division of Topps would set merchandising, advertising and promotion and sales personnel policies. Aca Joe could designate three of the five members of the Executive Committee.

Again, the Commissioner found that all elements of a franchise were present. The business was substantially associated with the Aca Joe trademark. Because Aca Joe could appoint the majority of the Executive Committee which had exclusive authority over merchandising, promotion and personnel, Aca Joe was prescribing a marketing plan in substantial part. And, the parties' profit sharing arrangement constituted a franchise fee.

In Huebner v. Sales Promotion, Inc., a Washington appellate court confirmed the trial court's decision that a partnership agreement constituted a franchise under the Washington Franchise Investment Protection Act ("WFIPA"), entitling the Washington investor to damages and rescission based on the unregistered sale of a franchise. Under the partnership agreement, the investor ("Huebner") contributed $100,000 and the supplier ("TCR") contributed 100 tire customizing machines. Huebner was required to rent all 100 machines within 365 days or be in default. Upon a default, TCR could terminate the agreement upon paying Huebner 25% of his investment. Six months after signing the partnership agreement, Huebner sued claiming that he was sold an unregistered franchise. The lower court granted Huebner's motion for summary judgment and TCR appealed.

The only element of the definition addressed by the appellate court was the license requirement. Finding that the partnership agreement gave Huebner the right to refer to himself as an "Authorized Tire Customizing Specialist" and that the term "Tire Customizing" was a trademark of TCR's corporate parent, the court found that TCR had granted Huebner a license to use its trademark and that a franchise existed.

However, in Commissioner's Opinion 4743F, the California Commissioner found no franchise to be created when a former employee and his employer formed a general partnership to appraise damage to automobiles. And, in Commissioner's Opinion 73/4F, the creation of a series of limited partnerships to engage in the business of automotive tune-ups was held not to create a franchise (although the opinion suggested a security may be present).

In a 1983 opinion, the California Commissioner examined a proposed general partnership arrangement between a business ("PDA") that appraised automobiles for insurance companies and its long-time employee, Hoover. The partnership was to operate a branch of the

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195 The court paraphrased the definition of franchise under the WFIPA as: "an oral or written agreement, either expressed or implied, in which a person grants to another person, a license to use a trade name, service mark, trade mark, logotype or related characteristic in which there is a community interest in the business of offering, selling, distributing goods or services at wholesale or retail, leasing, or otherwise and in which the franchisee is required to pay, directly or indirectly, a franchise fee." Id. Section 19.100.010(4) actually uses a marketing plan definition and provides that the associated trademark must be "owned by, or licensed by the grantor or its affiliate." Wash. Rev. Code § 19.100.010(4) (2011).
197 1983 Cal. Sec. LEXIS 1 (Nov. 25, 1983).
199 Supra note 197.
appraisal business in Stockton, California and Hoover was to act as the managing partner. The Commissioner identified the critical issue to be whether PDA would be prescribing a marketing plan or system in substantial part. The record showed that Hoover would have sole control over prices, credit practices and terms of payment, warranties, sales policies, training and supervision of sales personnel, whether to participate in and share the cost of PDA advertising and other business policies. PDA would supply sales aids, mutual advertising (sharing the cost), and consultation services, would present the partnership and its business to the public as part of a unified marketing plan and would grant the partnership the non-exclusive right to use its logo. Without any discussion or analysis, the opinion concludes that PDA did not prescribe a marketing plan or system in substantial part and that no franchise was created.200

A 1973 opinion201 reviewed the proposed creation of a series of limited partnerships between a company ("Dino-Dyno") and various members of the general public who would each invest $15,000 ("Limited Partners"). Dino-Dyno would serve as the general partner of the partnerships, each of which would operate under the name "Dino-Dyno No. xx." Profits and losses were allocated 51% to the general partner and 49% to the limited partners. Focusing on the part of the franchise definition that requires the franchisee to be granted "the right to engage in the business of offering, selling or distributing goods or services, the California Commissioner found there was no franchise since the limited partner had no right to conduct or control the partnership business and no authority to act for or bind the partnership.202

b. Exemptions and Exclusions

If a joint venture arrangement satisfies the definitional elements of a franchise and there is no exemption or exclusion, it will be deemed to be a franchise subject to federal and state franchise laws, regardless of the fact that the trademark owner also owns an interest in the joint venture.

The Original FTC Rule excluded general partnerships from coverage under the Rule.203 That specific exclusion was removed when the FTC Rule was amended in 2007; nevertheless, the FTC maintains that the exclusion is still viable.204

However, the exclusion is a limited one and has been very narrowly interpreted. In the Original SBP, the FTC stated that whether a relationship was a general partnership or a "franchise" was "a question of fact to be determined on a case-by-case analysis of the actual business practices of the parties involved."205 The Final Guides under the Original FTC Rule made it clear that to fall within the exclusion all partners had to be general partners; if the putative franchisor was shielded from liability as if it were a limited partner, the arrangement would not qualify for the exclusion.206

200 Id. at 3-4.
201 Supra note 198.
202 Id. at 4.
204 72 Fed. Reg. 15,530 (March 30, 2007); See also, FTC RULE COMPLIANCE GUIDE, supra note 27, at 15.
206 43 Fed. Reg. 59,968 (Dec. 21, 1978). There has been no guidance from the FTC as to whether a limited liability company, which is considered a partnership for tax purposes, could qualify for the general partnership exclusion.
Two Staff Advisory Opinions issued on the same day in 1993 further illuminated the FTC Staff’s narrow view of the exclusion. These two virtually identical opinions describe the two step analysis taken by the Staff in examining a general partnership for purposes of determining whether the exclusion applies.

First, the Staff will review the nature of each partner’s interest to determine whether they are in fact general partners. This part of the analysis focuses on whether each partner is free to exercise control over the partnership business and is not at an unfair disadvantage. The factors considered in making these determinations include: (i) the level of each partner’s ownership interest; (ii) the authority of each partner to bind the partnership; (iii) the actual level of control exercised by each partner; (iv) the nature of each partner’s contribution to the partnership, with particular scrutiny given to arrangements where one partner contributes the know-how and trademark with the other partner contributing the capital; (v) the extent to which each partner shares in the profits, losses and liabilities of the partnership; (vi) the extent to which individual partners are subject to unilateral restrictions, such as non-competition clauses or territorial restrictions; and (vii) the ability of each partner to terminate or transfer ownership interests.

The Staff will also consider whether the general partnership arrangement is bona fide. To aid in this determination, it will look at several factors, including: (i) whether a partnership arrangement is traditional in the particular industry; (ii) whether the partners have converted a traditional franchise relationship into a general partnership to avoid coverage under the FTC Rule; and (iii) whether one general partner has entered into multiple partnership arrangements.

The following factors also are considered relevant when one general partner has a series of general partnership arrangements: (i) the extent to which the partnerships engage in the same type of business and use similar methods of operation; (ii) whether the partnerships use the same trademark or trade name in marketing their products or services; (iii) whether the partnerships are created on a territorial or similar basis; and (iv) whether the common partner makes the same type of contribution to each partnership and exercises the same degree of control.

Even if an arrangement were to qualify for the federal general partnership exclusion, there is no corresponding general partnership exclusion among the franchise registration states.

Apart from the general partnership exclusion, what exemptions might be available? As discussed above, Staff Opinions No. 98-5 and No. 01-1 illustrate that the minimum payment exemption may apply, at least if there is no obligation to pay losses and no reasonable expectation of profits of at least $500 within the first six months following the commencement of operations. However, even if this or another federal exemption is available, arrangements that contemplate activities in the franchise registration states also must fall within an exemption at the state level. And, these state exemptions not only differ from the federal exemptions, but they also are not uniform among the registration states.


5. **Best Practices**

   a. Do not rely on the joint venture structure alone to avoid the franchise laws. If the elements of a franchise are present, the joint venture may be deemed to be a franchise even though the putative franchisor holds an ownership interest.

   b. Do not place any significant reliance on the federal general partnership exclusion. The exclusion is very narrowly construed, and there is no corresponding general partnership exclusion in the franchise registration states.

   c. Consider structuring the joint venture to take advantage of other available federal and/or state exemptions, recognizing that multiple exemptions may be required and that state level exemptions may be only from registration, not from disclosure.

   **D. Sales Representatives**

   The sales representative model is yet another business structure to consider as an alternative to the franchise model. Sales representatives are independent contractors that solicit wholesale orders for a company's products or services and who are compensated, in whole or in part, by commission.

   Unlike distributors, who purchase products or services from a supplier at wholesale and sell those products or services at retail, sales representatives only solicit orders for the company's products or services at retail. Instead of the sales representative taking possession and maintaining an inventory of the company's products, as distributors do, it is the company itself that develops and manufactures and then delivers the products to the ultimate customer. As such, sales representatives, unlike distributors, do not often need significant (or any) real estate and equipment to promote sales.

   Because the company actually delivers the products to the ultimate customer, it is also the company, and not the sales representative, that enters into a contract with (and later bills and collects from) the ultimate customer. The contract often obligates the sales representative, where the sale of services is involved, to provide on-going services to the ultimate customer.

   In such a case, the sales representative would receive extra compensation for additional services rendered.

   **1. Types of Sales Representatives**

   "Among sales representative relationships, two primary categories are of particular interest to franchisors: (1) Sales representatives that promote the sales of the principal's products or services to purchasers or end customers (sales representatives), and (2) Sales representatives that solicit franchisees or distributors on behalf of a franchisor or manufacturer and often [referred to as] development agents, area developers, regional developers, area representatives, and master franchisees (referred to collectively as area representatives)."

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209 Baer, et al., supra note 37.
210 McCullough and Baer, supra note 81.
211 Baer, et al., supra note 37.
212 Id.
This section of the paper focuses on the individuals described in the first category (true sales representatives).

Sales representative relationships may be oral and informal or written and formal; exclusive in territory or to a particular customer or market segment or non-exclusive; relate to the sale of products alone and/or to the sale of services; involve a sales representative who represents a number of companies and/or a variety of products and services or a sales representative who represents only one company and/or only one product or service line; and, may involve a sales representative who is also a distributor or who solely acts as a sales representative.\(^{213}\)

2. **The Sales Representative Model**

Sales representative agreements are typically in writing and they provide the following provisions: (i) appointment of agent, establishment of an agreement term and the designation of territorial rights (exclusive or non-exclusive); (ii) a clear description of the agent’s status as an independent contractor and an acknowledgement by the sales representative that it will represent to its clients that it is not affiliated in any with the company; it is not an agent and it has no authority to bind the company; (iii) definition of the scope of services that the sales representative will provide, including a list of approved products (or services) that the sales representative will be authorized to sell within the designated territory; (iv) a detailed list of the agent’s responsibilities, including the obligation to review all training materials and to train its employees, to conduct marketing within the territory, to conduct its own marketing, to strictly conform to the company’s standards regarding the use of all trademarks, service marks, etc., to not disclose the company’s proprietary information, and, to seek the company’s permission if the sales representative desires to engage in the marketing and solicitation of other products or services; (v) a detailed list of the company’s obligations under the agreement including, the obligation to provide all forms for use in connection with sales, to promptly review and service all contracts submitted by the sales representative, to handle all invoice processing and billing matters and to maintain records of the sales representative’s sales and clients; (vi) an explanation of the consideration that the sales representative will be paid, which will typically be a commission based on sales; (vii) provisions dealing with the parties’ respective indemnification rights and obligations; (viii) detailed provisions concerning termination or winding down of the relationship, including the parties’ post-termination obligations; and (ix) provisions dealing with choice of law/venue, assignment, modification of the agreement and other boilerplate provisions.

3. **Pros and Cons of Sales Representative Arrangements**

a. **Advantages of a Sales Representative Model**

Of course, a company may simply use its employees to solicit sales of its products and services. But there may be significant advantages for a company that either augments its internal sales force with sales representatives or uses a sales force that is comprised entirely of sales representatives. It may be that independent contractors have a level of knowledge or experience in the industry that far exceeds the knowledge or experience of the company’s own employees. Or it may be that the company operates in an industry that historically uses sales representatives so it only makes good business sense to use this model. It also could be that the use of independent sales representatives is an attractive model for a company that seeks to

\(^{213}\) McCullough and Baer, *supra* note 81.
delegate marketing responsibilities while maintaining control over the terms of sale.\textsuperscript{214} Finally, and most importantly, often times, the use of independent contractors is more cost effective for the company and/or produces a smaller risk of liability for the company than using its own employees.

Economically, a sales representative model may be more profitable because the company can sell its products and/or services at retail to a customer and then pay a sales representative a commission for soliciting the customer, thereby participating in the profit of the venture, rather than allowing a franchisee to sell its products and/or services in exchange for a modest royalty (typically between 5\%-10\%) on those gross sales.

In addition, the sales representative model is not subject to the myriad of federal and state franchise rules and regulations governing pre-sale registration and disclosure which are costly and time-consuming to comply with.

b. \textbf{Disadvantages of a Sales Representative Model}

There are, however, many disadvantages of the sales representative model. First, while the sales representative model is similar to a franchise model in that it provides a company an opportunity to expand rapidly using capital from third parties, it differs in a significant way. In a sales representative model, the company is responsible for delivering the ultimate product to the consumer. Thus, it must expend resources to accommodate an increased sales force and consumer demand.

Next, there are legitimate liability concerns associated with the use of sales representatives. While the sales representative agreement will make it very clear that the sales representative is not an agent of the company, there is a risk that a third party will be able to maintain a vicarious liability claim against the company for the negligent acts, errors and/or omissions of its sales representatives. In addition, there is a risk that the sales representative (or its employees) will be deemed to be the employees of the company, thus subjecting the company to tax liabilities and other state and federal laws governing the employment relationship.

Additionally, in the sales agent model, the company does not maintain the types of controls over the sales representative within the territory that it would under a franchise model. For example, the company cannot oversee the sales representative’s staff and typically will not have the ability to routinely inspect and oversee operations. As a result, if a sales representative is underperforming, the company may not be able to step in and take steps to improve operations for fear that if it exercises too much control over the operations, it exposes itself to liabilities under state and federal franchise laws as well as third party vicarious liability claims.

Finally, sales representative relationships (like franchises, dealerships and distributorships) are often regulated by separate state laws. For example, Puerto Rico and thirty-five states (Alabama, Arizona, Arkansas, California, Colorado, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Utah, Virginia, Washington and Wisconsin) have separate sales representative laws which are similar

\textsuperscript{214} Id.
to franchise relationship laws.²¹⁵ Three of those states' laws (California, Iowa and Nebraska) are not sales representative laws per se but, instead, are employee wage payment and collections acts that include special requirements for commissioned salespersons.

"Although the state sales representative laws vary considerably, typically they apply to principals who (i) do not have a place of business in the state, (ii) sell products at wholesale for resale, (iii) use sales representatives (who are independent contractors and not employees) to solicit wholesale orders for products within that state, and (iv) compensate the sales representative in whole or in part by commission."²¹⁶ Some statutes expressly exclude from coverage employees (Illinois, Kansas, Maryland, Massachusetts, Minnesota, New York, Ohio and Pennsylvania), those selling to ultimate consumers (Illinois, Kentucky, Ohio, Pennsylvania and South Carolina) and door-to-door salespersons (Kansas and Mississippi).

Essentially, the goal of the laws is to ensure that in-state sales representatives are compensated properly. In fact, all of the laws deal with the payment of commissions on termination and impose substantial liability for failure to pay or to pay in a timely manner.²¹⁷ Furthermore, the laws protect the sales representative at the end of sales representative relationship (i.e., termination, cancellation and non-renewal) in much the same way that franchise relationship laws protect franchisees.

4. The Sales Representative as a “Franchise”

The danger in a sales representative relationship is that the agreement will “cross the line” and be deemed a franchise. Sales representatives will often attempt to evoke the protections of a franchise law in an effort to challenge a manufacturer’s termination of the parties’ relationship.

There are generally two areas where a sales representative agreement can cross the line and become a franchise agreement. The first is the requirement of a fee. Of course, a sales representative agreement should not require the sales representative to pay an initial fee, whether marketing or promotional payments, training fees, or other remittances.²¹⁸ However, there are several indirect fees which could be found to be franchise fees or “required payments” under the FTC Rule.²¹⁹ In a sales representative model, a payment from the sales


²¹⁶ McCullough and Baer, supra note 81, at 34.

²¹⁷ Id. at 35.

²¹⁸ Baer, et al., supra note 37.

²¹⁹ See discussion in Section II, supra.
representative to a company for promotional literature or training kits; equipment and supplies could be deemed to be an indirect franchise fee.\footnote{220}

In addition to the payment of an indirect franchise fee, companies must also be mindful of the broad interpretation of "substantial control" under the FTC Rule and "prescribed marketing plan" and "community of interest" under state franchise laws. The exercise of any controls other than controls that are necessary to protect the company's rights under a trademark could be deemed to satisfy the requirements of state and federal franchise laws. Particular areas of concern under a sales representative model include: too much control over the sales process; the requirement to follow certain recruiting policies; training; hiring/firing of employees; and advertising or marketing of the product in the territory.

\textbf{a. FTC Guidance Regarding Substantial Control}

Advisory Opinion 04-3\footnote{221} involved a company that developed an Internet-based travel booking service and intended to enter into relationships with existing travel agencies and experienced travel professionals who would use, and earn commissions on consumers' bookings from the service. The company planned to exert some control over and offer continuing assistance to participating travel agencies/professionals, including: granting an exclusive geographic area in which to offer the service; requiring participants to use computer hardware and software that would enable them to access the service; requiring participants to report sales information; providing training relating to the services; requiring participants to maintain certain minimum standards relating to the use of the company's mark; requiring participants to expense a minimum amount on local marketing; and requiring participants to meet certain minimum sales thresholds.

In its analysis, the FTC Staff first concluded that, because the participating travel agencies/professionals were both well-established and engaged in a variety of other travel services unrelated to the company's Internet-based travel booking service, they were not likely to place great reliance on the company in the operation of their established travel businesses. Explaining further that reliance was relative to financial risk, the Staff concluded that the addition of the company's service to numerous other means employed in the participants' businesses was unlikely to pose a financial risk for the participants - and therefore unlikely to create significant reliance on the company. Finally, the Staff asserted that the company's assistance and controls appeared to be narrowly tailored to assure proper operation of the service (\textit{i.e.}, the participants' method of selling a product which represented a small part of the participants' businesses) as opposed to the operation of the participants' travel businesses as a whole (\textit{i.e.}, the entire method of operation). Thus, the FTC Staff concluded that the sales representative relationship was not a franchise under the FTC Rule.\footnote{222}

\textbf{b. Relevant Case Law}

In \textit{Averill v. Gleaner Life Insurance Society},\footnote{223} the court considered whether an insurance agency relationship constituted a franchise under the Michigan Franchise Investment Law ("MFIL"). Ultimately, the court granted the defendant-insurer's motion for summary

\footnotesize{\begin{itemize}
\item \textup{See discussion in Section II, \textit{supra}.}
\item \textup{Bus. Franchise Guide (CCH) \S 6523, June 7, 2004.}
\item \textup{\textit{Id.} at 3.}
\item \textup{2008 U.S. Dist. LEXIS 10073 (N.D. Ohio Jan. 29, 2008).}
\end{itemize}}
judgment on the basis that the marketing plan or system element was not present. According to
the defendant-insurer, the agreement between it and plaintiff specifically allowed the defendant-
insurer to market its insurance products as the plaintiff saw fit. As such, the defendant-insurer
argued that it did not prescribe in substantial part any marketing plan or system and the court
agreed.

In Sales & Marketing Associates, Inc. v. Huffy Corp., plaintiff sought protection as a
"dealer" under the Wisconsin Fair Dealership Law. Plaintiff was a company engaged in the
promotion and sale of products in the premium and incentive market, a specialized field that
involved marketing products to companies who use the products as incentives for their
salespeople or as premiums for marketing purposes. The governing agreement at issue was a
"sales representative" agreement, pursuant to which the plaintiff was appointed as the
representative of defendant, a sports equipment manufacturer, in the premium and incentive
field. The defendant sought to terminate the plaintiff under the sales representative agreement
and the sales representative commenced an action.

Pursuant to the sales representative agreement, the plaintiff solicited sales and
submitted purchase orders for those sales to the defendant and the defendant shipped the
products directly to customers. Although the defendant invoiced and engaged in collection
activities with respect to the largest accounts that the plaintiff solicited, the plaintiff invoiced and
engaged in collection activities with respect to a large number of the smaller accounts it
solicited. The plaintiff's personnel spent approximately 20-30% of their time on the defendant's
sales and the defendant's products accounted for approximately 23% of the plaintiff's gross
revenue each year.

Finding that there was no community of interest between the parties, the court examined
the combination of revenues and investments. Although the plaintiff relied to an extent on the
revenues from sales of the defendant's products, the court found that this reliance was not so
great that the plaintiff's economic health would be threatened by termination of the agreement.
Additionally, the court found no evidence that the plaintiff made any sizeable investments that
were tied to the defendant's products. Indeed, the plaintiff did not pay a franchise fee or make
any other investment in the defendant. Although the plaintiff did add staff, a larger facility and a
larger computer system during its marketing efforts, the court could not conclude that these
additions were tied solely to the plaintiff's relationship with the defendant. The fact that the
plaintiff would suffer lost profits as a result of the termination was not, by itself, enough to
establish a community of interest.225

224 Bus. Franchise Guide (CCH) ¶ 10,707 (7th Cir. 1995).
1987) (plaintiff sought protection under the Wisconsin Fair Dealership Law to prevent termination of dealership
agreement but court found no community of interest because the dealer represented a significant number of other
manufacturers and had no significant economic stake in the relationship.); and, Hemmenich v. International China
Co., Inc., Bus. Franchise Guide (CCH) ¶ 9198 (W.D. Wisc. 1988) (another case under the Wisconsin Fair Dealership
Law but the court found that there was a community of interest between an independent sales representative and a
china manufacturer because the parties had continuing financial interests and interdependence where the
representative: (a) had been the manufacturer's sole dealer in the Midwest for five years; (b) had derived over 60% of
its revenue from the sale of the manufacturer's products; (c) had devoted over 70% of its time and resources to the
sale of the manufacturer's products; (d) maintained an inventory of those products; and (e) invested more than
$15,000 in developing a business primarily selling the manufacturer's products.)

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In Blankenship v. Dialist International Corp\textsuperscript{226}, the court determined that a sales representative was in fact a "franchisee" under the Illinois Franchise Disclosure Act since it sold or distributed products under a marketing plan prescribed by the manufacturer, used the manufacturer's trade name and paid a franchise fee for the right to engage in business in Illinois.

When focusing on the marketing plan element of a franchise, the court noted that Illinois provides that a marketing plan can be prescribed or suggested. Therefore, the element would be satisfied even if the franchisee merely had the contractual right, as opposed to being required, to use the manufacturer's marketing plan. And indeed the franchisee did have a contractual right to sell under a market plan since the franchisee was furnished with a detailed explanation of the manufacturer's distribution system, instructions on how to market the product, a manual detailing product information and sales tips, sample advertising and promotional material. The fact that the sales representative had the freedom to develop its own territory and sales staff without interference from the manufacturer did not destroy the marketing plan element.\textsuperscript{227}

5. **Best Practices**

There are several best practices to follow when entering into a sales representative agreement.

a. **No Initial Franchise Fee**: Do not require the sales representative to pay a direct or indirect franchise fee. Counsel must fully understand the broad scope of franchise laws and ensure that nothing in the agreement can be construed as a franchise fee or required payment. The company must understand that there is always a risk that sales kits, required training or marketing programs could be interpreted as franchise fees. Additionally, "[i]f the franchisor-principal has the right to withhold fees via commission offsets, the sales representative agreements should indicate that commission offsets are the only, or at least the preferred, method of collection and that such fees are not collectible directly from sales representatives if there are no sales to generate commissions."\textsuperscript{228} Instead of stating or implying that fees are payable directly by the sales representative to the principal, principals should ensure that the parties' contract defines commissions as a net concept (i.e., a portion of sales minus expenses).\textsuperscript{229}

b. **Limited Controls Over the Business Operations**: Be certain that the control exercised by the company over the sales representative's business are limited to controls that are necessary to protect the company's federal trademark rights.


\textsuperscript{227} \textit{Id.}; See also, \textit{EBI, Inc. v. Gator Industries, Inc.}, Bus. Franchise Guide (CCH) ¶ 8726 (1st Cir. 1986) (holding that sales representative that did not make any investment in promotion, inventories or facilities; lacked the authority to close sales; and had no responsibilities for credit, collections, or deliveries was not a "dealer" within the Puerto Rico relationship/termination law.); and \textit{Kent Jenkins Sales, Inc. v. Angelo Brothers Co.}, Bus. Franchise Guide (CCH) ¶ 8700 (W.D. Ark. 1986) (holding that a manufacturer's representative that lacked the right to sell the manufacturer's products was not a "franchisee" under the Arkansas franchise relationship law. According to the court, because the representative did not take title or possession of any of the manufacturer's products, it promoted or solicited sales, rather than sold goods and as a result, was not entitled to the protections of the Arkansas franchise relationship law.)

\textsuperscript{228} Baer, et al., \textit{supra} note 37.

\textsuperscript{229} \textit{Id.}
c. **Limited Obligations Imposed on the Sales Representative:** As discussed in Section II.C.2.b of this paper, a factor that is considered in determining whether there is a community of interest between two contracting parties (in states where "community of interest" is an element of a franchise) is the extent and nature of the obligations imposed on the parties in their contract or other agreement. As such, a principal that seeks to avoid the reach of the federal or state franchise laws should ensure that it does not require extensive follow-up work, large investments or use of its logo or trademark in conjunction with sales. Instead, the sales representative's obligation should be limited to soliciting business for the principal.

d. **Protection Against Claim for Vicarious Liability:** The sales representative agreement must require the sales representative to advise all employees and customers that it is an authorized, independent sales representative and that it is not an employee or agent of the company. All forms, business cards, employment applications, advertisements and the like must also contain similar disclaimers. Furthermore, the parties' contract should not contain language that grants the sales representative the right to bind the principal to sales contracts procured by the sales representative.

e. **Key Acknowledgements:** Require the sales representatives to acknowledge in the agreement that the relationship is not a franchise and to also agree to never contend otherwise.

f. **Avoid Certain Contractual Language:** Principals should avoid contract language that: (1) conveys the title to goods to sales representatives; (2) classifies expense reimbursements or charges as expenses or costs of the sales representative (they should instead be factored in as an adjustment to the definition of commissions); (3) classifies commission reductions as any kind of a penalty or fee (reductions should only be made for business operating expenses or for not performing a service that entitles the sales representative to his full commission); and (4) requires sales representatives to dedicate a large portion of their facilities or personnel to the principal's sales.

E. **Exemption-Based Franchising**

This paper has examined distribution models that may provide an alternative to a franchise structure. However, if an alternative structure does not satisfy the client's business goals, one way to alleviate some of the regulatory burdens associated with franchising is to utilize available exemptions from federal and/or state regulatory requirements. The FTC Rule contains several exemptions from the requirement to provide a FDD to prospective franchisees. The exemptions are only from the requirement to provide disclosure, not from the other provisions of the Rule.

One of the difficulties in structuring a nation-wide franchise program that relies on an exemption-based approach is that the principal exemptions available under the FTC Rule are not available in all of the franchise registration states. Even where corresponding state exemptions are available, they are often exemptions from registration only, not from the requirement to provide disclosure. Thus, even if a franchisor is able to rely on a federal

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230 Id.
231 Id.
232 The exemptions are only from the requirement to provide disclosure, not from the other provisions of the Rule.
233 An excellent discussion of federal and state exemptions, including a chart comparing the availability of specific exemptions at the federal and state levels, can be found in Karen B. Satterlee and Leslie D. Curran, *Exemption-Based Franchising: Are You Playing in a Minefield,* 28 Franchise L.J. 191 (2009). See also Earsa R. Jackson and
exemption from disclosure in the non-registration states, it may nevertheless be required to make disclosure and/or register in the franchise registration states.

One useful exemption that is broadly available at the state level is the large or seasoned franchisor exemption. Although not a disclosure exemption, it does permit qualified franchisors to bypass the often time-consuming registration process. This exemption is available under various names in all of the franchise registration states except Hawaii, Michigan, Minnesota, South Dakota and Wisconsin. However, of those five states, only Hawaii and Minnesota have a registration review process; the other three states are notice filing states. The downside of this exemption is that in many states it includes an experience component in addition to a net worth component. This makes the exemption practically unavailable to new franchisors.

Even if a broad-based exemption program is not feasible, the use of exemptions in discrete transactions can be beneficial. These exemptions may even be useful (or necessary) in conjunction with one or more of the alternative distribution models discussed in this paper where there is a concern that attributes of the alternative structure may trigger application of the franchise laws. However, a clear understanding of the scope of the exemption is required.

Compare, for example, the use of the minimum payment exemption in Op. 98-5 and Op. 01-1, discussed at Section III.C.4. of this paper. Each opinion addressed the use of the minimum payment exemption in the context of a joint venture arrangement. But the minimum payment exemption was used successfully only in Op. 01-1, where the putative franchisee’s obligation to pay its share of the venture’s losses did not occur until more than six months after business operations commenced. In the joint venture that was the subject of Op. 98-5, consulting fees paid to the putative franchisor were not due until after the requisite six month period, but payment of its share of any profits from the joint venture were not similarly restricted. Accordingly, the structure did not clearly avoid the fee element of the franchise definition.

IV. CONCLUSION

Some industries may be well-suited to distribution models other than franchising. A soft drink company may license bottlers to produce and distribute its product. An automobile or heavy equipment manufacturer may distribute its cars or equipment through dealers or distributors. A pharmaceutical company may utilize third party sales representatives to market its products. The creator of a retail clothing line may license a manufacturer to produce that line. However, anyone using these distribution models should be aware of the potential applicability of the franchise laws. And persons who seek to avoid compliance with the franchise laws by structuring what should otherwise be a franchise as one of these alternative models should understand that it is a risky exercise.
Ann Hurwitz, Baker Botts L.L.P.

Ann Hurwitz chairs the Franchise and Distribution Section at Baker Botts L.L.P. For over 25 years, she has counseled clients on the worldwide distribution of products and services. She has deep experience in the structuring and operation of domestic franchise programs and international expansion, with a particular focus on the complex issues arising from the ownership of multiple concepts, the offer of co-branded opportunities, brand acquisition and disposition, the use of alternative distribution channels, and the restructuring of distribution systems. Ms. Hurwitz represents companies in a variety of industries, including the hotel, restaurant, retail, and convenience store industries.

Ms. Hurwitz is included in An International Who's Who of Franchise Lawyers. She is listed in the 2010 edition of The Best Lawyers in America and has been listed in that publication every year since 1995. Ms. Hurwitz has been repeatedly selected as a Texas Super Lawyer and named one of the Best Lawyers in Dallas by D Magazine. She is also listed in the 2010 Who's Who Legal: The International Who's Who of Business Lawyers and has been named inFranchise Times' “Legal Eagles” as one of the top 101 franchise lawyers in the US and Canada. The respected English publisher Chambers and Partners cites her in Chambers USA: America's Leading Lawyers for Business noting that "observers applauded her 'thoughtful, creative and articulate approach to problem solving.'"
David W. Oppenheim – Speaker Bio

Mr. Oppenheim is a Partner of Kaufmann Gildin Robbins & Oppenheim LLP (New York City). He is the Chair of the New York State Bar Association Business Law Section’s Franchise, Licensing and Distribution Committee; and is a member of the Executive Committee of the Business Law Section of the New York State Bar Association, the International Franchise Associations’ Legal Legislative Affairs Committee, and the American Bar Association’s Forum on Franchising. Mr Oppenheim is featured in Best Lawyers in America; has been repeatedly selected as a New York Superlawyer; and, is featured in the Franchise Times’ as a “Legal Eagle” - one of the top 101 franchise lawyers in the US and Canada. He is a frequent author and speaker on topics relating to franchising and distribution systems for the American Bar Association, the International Franchise Association, the New York State Bar Association and the New York City Bar Association. Mr. Oppenheim is the co-author of the annual Franchise Practice Commentary appearing in McKinney’s New York Statutes; the IFA’s An Introduction to the Law of Franchising (2007, 2008, 2009, 2010); and, CCH’s seminal analysis of the revised FTC Franchise Rule entitled FTC Disclosure Rules for Franchising and Business Opportunities - Highlights and Analysis (2007). He has also served as a member of the Editorial Advisory Board for the International Journal of Franchise Law since 2008.

Mr. Oppenheim’s practice focuses on planning, structuring and implementing national and international franchise, licensing and distribution programs for emerging and mature franchisors. He also concentrates on franchise-related mergers and acquisitions and related financing transactions; the modification of mature franchisors’ networks; franchise royalty securitizations; drafting franchise and license agreements, ancillary agreements and franchise disclosure documents (and securing registration of same both domestically and internationally).