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Unintentional Franchising.

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UNINTENTIONAL FRANCHISING

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I. INTRODUCTION

A. *Synopsis*

The focus of this Article is on honest businesses that do not realize they may be legally regulated as "franchisors" or "business opportunity sellers" and subject to potentially awful consequences due to noncompliance. This Article first discusses federal and other states' laws, then the Texas Business Opportunity Act (BOA), and finally, practical and litigation consequences.

B. *In General*

Franchising is a method of distribution that combines the advantages of a branded, centralized, specialized system with the capital and micro-management of local independent business persons to produce a market competitor with critical mass. It can leverage a business's success far beyond its own capital and management resources. Franchising's inherent geographic expansiveness and long-term business relationships cause it to be affected by an array of dynamic federal, state, and local laws. Lawyers refer to the irregular collection of laws applicable to relationships arbitrarily defined as "franchises" as franchise law.

Franchise law is similar to securities law in several aspects. First, both are an exercise of the government's police power to protect consumers concerning a type of consensual business deal that government decided is too often abusive. In response to a wave of fraud and abuse complaints in the 1960s and 1970s, the Federal Trade Commission (FTC) promulgated the Franchising and Business Opportunity Ventures Trade Regulation Rule (FTC Rule) in 1979 to protect prospective buyers from deceptive franchise and business opportunity sales practices.[1] Fifteen states have enacted

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1. *See* Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. § 436.1 (2004) (codifying 43 Fed. Reg. 59,614 (Dec. 21, 1978)). The history of the rule is similar to the history of most public policy and police power intrusions into business law. For example, in the 1920s, the citizenry eagerly and voluntarily traded large amounts of money for stock with an expectation of safe fat profits. Those investments were lost in the 1929 market crash, after which the citizenry complained loudly to government. Government responded with the Securities and Exchange Acts of 1933 and 1934 and similar police power statutes in all states. *See* Securities Act of 1933 § 5a, 15 U.S.C. § 77e (2004) (enacting prohibitions on the interstate sale of securities unless a registration statement is in effect as to those securities); Scott Daugherty, Comment, *Uncharted Waters: Securities Class Actions in Texas After the Securities Litigation Uniform Standards Act of 1998*, 32 ST. MARY'S L.J. 143, 183-83 (1999) (indicating that in response to the enormous number of worthless securities sold to Texas citizens in the 1920s and 1930s, and the resulting public outcry, the legislature enacted the Blue Sky Law of Texas—and later the Texas Securities Act of 1935—to protect investors from fraud). These statutes made a class of business deals between consenting adults illegal unless specific buyer protection rules were followed. *See* Securities Act of 1933, § 5a, 15 U.S.C. § 77e (2004) (prohibiting the interstate sale of securities unless a registration statement is in effect as to those securities); The Securities Act, TEX. REV. CIV. STAT. ANN. art. 581, § 12 (Vernon Supp. 2004) (prohibiting selling or offering to sell unregistered securities within Texas). The historical parallel to the enactment of franchise police power regulation is apparent. In the 1960s and 1970s, the public invested in worm farms, chinchilla ranches, etc.; those markets crashed, the public complained to government, and government enacted franchise

franchise statutes, and twenty-five have enacted business opportunity statutes.[2] Appendix A lists these statutes.

Second, neither franchise nor securities law dictates a deal's terms. Whether or not the buyer gets a good deal is unregulated.[3] These laws require a written pre-sale disclosure in a prescribed format to prospective buyers and, in some states, pre-sale registration of the offering. They are intended to help consumers make intelligent decisions.

Third, the threshold "security,"[4] "franchise," and "business opportunity" definitions that determine what deals are covered are intentionally drafted broadly to protect buyers, heedless of the

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and business opportunity regulations. H. Bret Lowell & John F. Dienelt, *Drafting Distribution Agreements*, 11 DEL. J. CORP. L. 725, 727 (1986); *see also* Appendix A (listing states' franchise and business opportunity statutes).

2. Much heat and noise is expended on the correct count of states having such laws, and there are many good arguments about the actual number. For example, Texas is not listed in Appendix A as a franchise state because FTC Rule compliant franchise sales are expressly exempted from the Texas Business Opportunity Act (BOA) and arguably a careful seller is not included within the BOA's scope. TEX. BUS. & COM. CODE ANN. § 41.004(a) (Vernon 1994). However, as discussed below, if a jury believes the seller represented that the buyer was likely to earn a profit ("Mr. Seller, please tell the jury what words you spoke in selling this business opportunity to Mr. Buyer"), then likely the seller is within the BOA's scope. Further, the BOA's franchise exemption is limited to sellers who (1) are FTC Rule franchisors, (2) comply with the FTC Rule, *and* (3) file an exemption statement with the Texas Secretary of State along with a small fee. *Id.* § 41.004(b)(8).

3. *See* 15 U.S.C. § 45(n) (2000) (stating that "[t]he Commission shall have no authority . . . to declare unlawful an act or practice on the grounds that such act or practice is unfair unless the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition"). "Today the fraud is not in the presale, the fraud is in the contract." *AFA President Discusses the Challenges of Being a Franchisee*, FRANCHISING BUS. & L. ALERT (L.J. Newsletters, Philadelphia, Pa.), Jan. 2004, at 1, 2 (quoting Susan Kezios, the president and founder of the American Franchisee Association). Some states arguably get into the business of deciding whether a deal is appropriate by imposing an impound upon a weak new franchisor's sales of franchises into their state. *See, e.g.*, CAL. CORP. CODE ANN. § 31113 (Deering Supp. 2004) (authorizing the state to impound franchise fees until the franchisor has fulfilled the obligations under the disclosures); HAW. REV. STAT. ANN. § 482E-8(e) (Michie 2003) (providing authority to impound franchise fees to protect franchisees). Both California and Hawaii escrow each state's franchisees' payments to the franchisor in a local bank until the franchisor's start-up obligations are complete. *Id.* As a practical matter, an impound requirement typically excludes the franchisor from the subject state.

4. The definition of "security" is sweepingly broad. *See* Securities Act of 1933 § 2(a), 15 U.S.C. § 77b(a)(2) (2004) (defining "security" for purposes of federal law); Reves v. Ernst & Young, 495 U.S. 56, 57 (1990) (commenting that Congress's definition of "security" is broad enough to include virtually any form of investment). *See generally* LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES REGULATION 155-170 (5th ed. 2003)

sometimes disproportionate adverse effect on sellers. To the astonishment of the attorneys and business persons involved, courts often deem many ordinary trademark licenses, distribution agreements, technology licenses, joint marketing agreements, and plain vanilla business deals as franchises or business opportunities.[5]

Fourth, a noncompliant sale of an unregistered franchise, like a noncompliant sale of an unregistered security, or misrepresentations made in those sales, can be illegal, even if they are consensual great deals. Business persons are accustomed to being successful without having gone to law school because business law generally incorporates common-sense business expectations. They expect business agreements between consenting adults to be enforced. Unintentional franchisors do not appreciate the consumer protection scope and police power effect of franchise law. Franchise and securities laws are *not fair*. They *are* out to get you. Non-compliance can result in a business death penalty, personal liability,[6] and malpractice awards.

After decades of seeing the rich and famous do the "perp walk" on the nightly news for securities violations, there is a pervasive common-sense understanding among all classes of the population concerning the implications of securities law. In contrast, few attorneys or business persons have franchise law on their radar

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(providing a historical background on the evolution of the term "security" under federal securities Law).

5. *See* H. Bret Lowell & John F. Dienelt, *Drafting Distribution Agreements: The Unwitting Sale of Franchises and Business Opportunities*, 11 DEL. J. CORP. L. 725, 726 (1986) (noting that many attorneys fail to understand that a franchise may be "any form of product or service distribution agreement in which the franchisee is identified with the provider of the goods or services"); Kenneth H. Slade, *Applicability of Franchise and Business Opportunity Laws to Distribution and Licensing Agreements*, 15 AIPLA Q. J. 1, 1 (1987) (citing hypothetical situations that could all easily be covered under typical franchise and business opportunity laws, despite that attorneys may never have considered that this may be an issue; indicating that franchise and business opportunity laws have "a broad, and often unexpected, reach").

6. *See* Bixby's Food Sys., Inc. v. McKay, 193 F. Supp. 2d 1053, 1062-63 (N.D. Ill. 2002) (concluding that a summary judgment against the president of a franchisor was proper under the Illinois Franchise Disclosure Act, which holds principal executive officers and directors of corporations jointly and severally liable if they had knowledge of the facts). In *Bixby*, the president of a franchisor was held to have violated the Illinois Franchise Disclosure Act by falsely claiming the franchisor had more franchisees than it really had. *Id.* at 1062. In contrast, the franchisees' motion for summary judgment with respect to common law fraud was rejected because the franchisees failed to show by clear and convincing evidence that their reliance on the false oral statement was reasonable. *Id.* at 1066.

screen, and many who do underestimate its scope and effect. Consequently, businesses often make mistakes in the franchise arena. The most common reaction to being told that a business is a franchisor is: "Who? Me?"

Texas business persons and attorneys are particularly vulnerable to inadvertent franchising problems. Attachment A shows registration states concentrated in an arc running along the coasts and industrial Midwest—regions where governmental protection/interference is accepted. In contrast, the culture of southwestern and southern states tends more to "leave-me-alone" rugged independence. When successful Texas businesses expand into "governmental regulation" states, they are often easy prey for the sophisticated franchisee bar[7] and active state franchise administrators.[8]

To further complicate the issue, franchising bundles together many areas of law that are typically only dealt with by specialists: federal and state laws concerning antitrust,[9] trade dress,[10] trade secrets, general advertising, franchise advertising, patents, trade-

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7. *See* Dady & Garner, P.A., *at* http://www.dadygarner.com (last visited Oct. 11, 2004) (promoting its practice as limited to representation of franchisees, distributors, and dealers). Law firms specializing in suing franchisors, often on a contingent fee basis, exist in the registration states. These firms have considerable expertise and experience in franchise litigation. While Texas has contingent fee law firms that specialize in nursing home suits, physician malpractice, and bodily injury cases, Texas does not have law firms that specialize in franchise contingent fee litigation. National franchise associations, such as the American Franchise Association and American Association of Franchisees and Dealers, refer unhappy franchisees to such attorneys.

8. Particularly active state franchise administrators are found in California, Illinois, and Virginia.

9. Price fixing and undisclosed brokerage discounts are typical antitrust claims. *See* 15 U.S.C. § 13(c) (2000) (prohibiting brokerage commissions to persons under the direct or indirect control of a party to the transaction unless that party is the party paying the commission). *See generally* Panel Discussion, *A New Wave of Robinson–Patman Act Section 2(c) Litigation: Auto-Brokerage Claims in the Franchise Supply Context*, THE ANTITRUST SOURCE, July 2003, *at* http://www.abanet.org/antitrust/source/july03/brownbag.pdf (providing the discussion of a "Brown Bag" conference call "co-sponsored by the Section's Robinson-Patman Act and Corporate Counsel Committees").

10. *See* Two Pesos, Inc. v. Taco Cabana, Inc., 505 U.S. 763, 776 (1992) (holding that "proof of secondary meaning is not required to prevail on a [Lanham Act] claim . . . where the trade dress at issue is inherently distinctive"). Trade dress, which is the "overall appearance and image in the marketplace of a product or a commercial enterprise," BLACK'S LAW DICTIONARY 1500 (7th ed. 1999), is protectable under federal law. *See Two Pesos*, 505 U.S. at 768 (noting that the Lanham Act prohibits the deceptive and misleading use of marks).

marks, copyrights,[11] vicarious liability,[12] bankruptcy,[13] arbitration,[14] forum selection,[15] conflict of laws, real property, usury, unfair competition, covenants of good faith and fair dealing, business relationship anti-termination and anti-discrimination laws, state "baby FTC" acts,[16] the contract and tort law applied by each applicable jurisdiction, and local, state, and federal regulations affecting the subject line of commerce. Any of these can be the downfall of a distribution system.

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11. *See* Patrick F. McGowan & John M. Cone, *The Increasing Value of Copyright Protection in a Franchise Context*, FRANCHISE L.J., Fall 1998, at 14 (explaining how copyrightable works may be important to the operation, promotion, and public perception of franchises).

12. *Compare* Fitz v. Days Inn Worldwide, Inc. No. 04-02-00487-CV, 2004 Tex. App. LEXIS 4688, *7-10, *15 (Tex. App.—San Antonio May 26, 2004, pet. filed) (affirming summary judgment for a franchisor in a case emanating from a hit-and-run incident that occurred on the sidewalk of the franchisee's premises where the franchisor had drafted the franchise agreement to contractually avoid a right of control over the franchisee), *and* Chevron U.S.A., Inc. v. Lesch, 570 A.2d 840, 850 (Md. 1990) (concluding that the facts did not support a finding of vicarious liability against Chevron), *with* Hoytt v. Docktor Pet Ctr., No. 85 C 6850, 1986 U.S. Dist. LEXIS 19296, at *6-7 (N.D. Ill. Oct. 10, 1986) (considering whether a purchaser of a dog from a pet-store franchisee had a cause of action against the franchisor under the doctrine of apparent authority). *See generally* John C. Monica, *Franchisor Liability to Third Parties*, 49 MO. L. REV. 309 (1984) (discussing vicarious and direct liability by franchisors to third parties).

13. *See generally* Jeffrey R. Seul, Comment, *License and Franchise Agreements As Executory Contracts: A Proposed Amendment to Section 365 of the Bankruptcy Code*, 59 U. COLO. L. REV. 129 (1988) (proposing an amendment to 11 U.S.C. § 365 to protect nondebtor entities from hardship resulting from a licensor's or franchisor's liquidation or reorganization efforts).

14. *See generally* Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987) (discussing enforceability of arbitration agreements on claims brought by a customer against a broker); Marble Slab Creamery, Inc. v. Wesic, Inc., 823 S.W.2d 436 (Tex. App.—Houston [14th Dist.] 1992, no writ) (reviewing a franchisor's waiver of the right to require arbitration).

15. *See In re* AIU Ins. Co., No. 02-0648, 47 Tex. Sup. Ct. J. 1093, 2004 Tex. LEXIS 783, at *10 (Tex. Sept. 3, 2004) (indicating that forum selection clauses have the positive effect of eliminating any confusion about where a case should be tried).

16. The buyer of a franchise can often avail himself of a state's general consumer fraud statute. *See* Kavky v. Herbalife Int'l of Am., 820 A.2d 677, 684-85 (N.J. Super. Ct. App. Div. 2003) (holding that Herbalife's internet sales into New Jersey were not subject to New Jersey's Franchise Practices Act, but were still subject to the New Jersey Consumer Fraud Act); Lund v. Arbonne Int'l, Inc., 887 P.2d 817, 823 (Ore. Ct. App. 1994) (concluding that a cosmetics company did not violate Oregon's Unlawful Trade Practices Act when it terminated a consultant's agreement as an independent contractor). *Contra* J & R Ice Cream Corp. v. Cal. Smoothie Licensing Corp., 31 F.3d 1259, 1274 (3d Cir. 1994) (determining that franchises or distributorships are not covered by the Consumer Fraud Act because they are not sold for consumption).

C. *Federal Franchise Regulation*

The FTC Rule defines an arrangement as a "franchise" if it (1) requires the buyer to *pay at least $500*; (2) for the right to operate a business under the seller's trade name or to sell the seller's branded products; and (3) the franchisor provides *significant assistance* to the buyer *or* can exercise *significant control* over the buyer's operating methods.[17] The FTC Rule makes it unlawful for a franchisor not to provide written disclosures to prospective franchisees at the earlier of (1) the first face-to-face meeting between the franchisor and the prospective franchisee for the purpose of discussing the possible sale of a franchise[18] or (2) ten business days prior to executing the franchise agreement.[19] The FTC Rule does not require any governmental filings—just disclosure in the prescribed way.[20] Importantly, it does not provide a private cause of action.[21]

After nearly ten years of work, the FTC released a 423-page staff report on August 25, 2004 (2004 FTC Staff Report) that recommends various changes in the FTC rule.[22] The FTC's input for action against non-compliant businesses primarily comes from complaints and annual national sweeps of one day's internet, newspaper, and other advertising.[23] The sweeps produce several thousand hits, which are delegated to the FTC or different states for

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17. 16 C.F.R. § 436.2(a) (2003).

18. *See* 16 C.F.R. § 436.1(a) (2003) (requiring disclosure "at the earlier of the 'time for making of disclosures' or the first 'personal meeting'"); 16 C.F.R. § 436.2(o) (2003) (defining "personal meeting" to mean "a face-to-face meeting between a franchisor or franchise broker . . . and a prospective franchisee which is held for the purpose of discussing the sale or possible sale of a franchise").

19. 16 C.F.R. § 436.2(g) (2003).

20. 16 C.F.R. § 436.1 (2003).

21. *See* Tex. Cookie Co. v. Hendricks & Peralta, Inc., 747 S.W.2d 873, 877 (Tex. App.—Corpus Christi 1988, writ denied) (indicating there is no private federal remedy for failing to make disclosures required by the FTC); *see also* Carlson v. Coca-Cola Co., 483 F.2d 279,280-81 (9th Cir. 1973); Holloway v. Bristol-Myers Corp. 485 F.2d 986, 986 (D.D.C. 1973) (stating that FTC actions may not be maintained by private parties); Randolph v. Oxmoor House, Inc., No. SA-01-CA-0699-FB, 2002 U.S. Dist. LEXIS 26289, *16-17 (W.D. Tex. Sept. 30, 2002).

22. Bureau of Consumer Prot., Fed. Trade Comm'n, Disclosure Requirements and Prohibitions Concerning Franchising: Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR Part 436), 1 (Aug. 2004), *at* http://www.ftc.gov/os/2004/08/0408franchiserulerpt.pdf.

23. *See* Press Release, Federal Trade Commission, "Operation Money Pit" Targets Fraudulent Business Opportunity Schemes (Feb. 20, 1998), *available at* http://www.ftc.gov/

further review. If the government Consumer Sentinel database shows matching consumer complaints,[24] the odds of a business being screened for further investigation rise.

If screened in, a business receives a polite investigatory letter from the FTC or designated state administrator inviting the business to explain the complaints. Consumer complaints will also trigger such a letter. Businesses sometimes do not take these letters seriously and either ignore them or respond with hostility—a big mistake.[25] These inquiry letters should be taken to an attorney specializing in the matter for a prompt, polite, and comprehensive response. The FTC is unlikely to take meaningful action against an inadvertent franchisor who is otherwise a good actor and promises to comply going forward.[26]

D. *State Franchise Laws*

State laws generally define franchising similarly to the FTC Rule, but differences between the states' definitions and exemptions can be crucial to determining whether a particular sale was or was not the sale of a franchise. California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oklahoma, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin require a registration or notice-filing before offering franchises for sale, and pre-sale disclosure through twenty items in

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opa/1998/02/moneypit.htm (describing fourteen actions announced as part of a mini-sweep targeting sellers of fraudulent business opportunities).

24. *See* Consumer Sentinel, *at* http://www.consumber.gov/sentinel/index.html (allowing various law enforcement agencies to access consumer complaints about various fraud). The Consumer Sentinel is a government database of consumer and other complaints from all possible sources.

25. *See generally* BUREAU OF CONSUMER PROT., FRANCHISE AND BUSINESS OPPORTUNITY PROGRAM REVIEW 1993-2000: A REVIEW OF COMPLAINT DATA, LAW ENFORCEMENT AND CONSUMER EDUCATION (June 2001) (analyzing the FTC's franchise and business opportunity program from 1993-2000). From 1993 through 2000, the FTC received 4512 complaints about franchisors and business opportunity sellers. *Id.* at 5. The FTC initiated fifty-nine investigations against traditional franchisors, twenty-two of which resulted in an .enforcement action. *Id.* During the same time period, there were 273 investigations against business opportunity sellers, of which 148 resulted in an enforcement action. *Id.* Between the large complaint numbers and small investigation numbers lie the bulk of businesses who either make restitution or promise future compliance and show that there is an insufficient basis for FTC action.

26. The odds of the FTC initiating an enforcement action increase with the number of complaints and the unsatisfactory nature of the business's response.

a prescribed format called a Uniform Franchise Offering Circular (UFOC).[27] Also, Oregon requires pre-sale disclosure without a governmental filing.[28]

The internet multiplies the likelihood of trouble, as a business that inadvertently "offers" a "franchise" under a state's laws triggers that state's registration and disclosure requirements.[29] Failure to comply with franchise law may give franchisees the right to rescind the agreement or obtain enhanced damages.[30]

E. *Business Opportunity Laws*

Business opportunity laws apply to sellers who offer purchasers the opportunity *to begin a business* by using the seller's goods or

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27. CAL. CORP. CODE ANN. § 31110 (Deering Supp. 2004); HAW. REV. STAT. ANN. § 482E-3(b) (Michie 2004); 815 ILL. COMP. STAT. 705/10 (2004); IND. CODE ANN. § 23-2-2.5-9(1) (Michie 2004); MD. CODE ANN., BUS. REG. § 14-214 (2004); MICH. COMP. LAWS § 445.1507a (2004); MINN. STAT. ANN. § 80C.02 (West 2003); N.Y. GEN. BUS. LAW § 683 (McKinney 2004); N.D. CENT. CODE § 51-19-03 (2003); OKLA. STAT. ANN. tit. 71, § 806 (West 2004); R.I. GEN. LAWS § 19-28.1-5 (2004); S.D. CODIFIED LAWS § 37-5A-6 (Michie 2004); VA. CODE ANN. § 13.1-560 (Michie 2004); WASH. REV. CODE ANN. § 19.100.020 (West 2004); WIS. STAT. ANN. § 553.21 (West 2003).

28. *See* OR. REV. STAT. § 650.010 (2003) (requiring that anyone offering to sell a franchise must maintain a complete set of books concerning the sale and provide any purchaser's name and the amount of proceeds received to the state).

29. *See generally* N. Am. Sec. Adm'rs Ass'n, Statement of Policy Regarding Offers of Franchises on the Internet (May 3, 1998) (addressing issues related to franchisors' increasing use of the Internet), *at* http://www.nasaa.org/nasaa/scripts/fu_display_list.asp?ptid=72 (last visited Oct. 25, 2004). A franchisor should consider stating on its website: "This information is not intended as an offer to sell, or the solicitation of an offer to buy, a franchise. It is for information purposes only." *See id.* (proposing the use of cautionary language by the franchisor to exempt offers made via the Internet from franchise registration requirements of the state). Alternatively, a website should indicate:

> Currently, the following states and countries are the only states and countries where we are offering to sell franchises. If you are not a resident of one of these listed states or countries, we will not offer you a franchise unless and until we have complied with applicable pre-sale registration disclosure requirements in your jurisdiction.

See id. (proposing the use of cautionary language by the franchisor to exempt offers made via the Internet from franchise registration requirements of the state).

30. *See* Hicks v. United Snack Group, Inc., [1992-1993 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 10,131 (W.D. Wash. Dec. 9, 1992) (deciding that a franchisee was entitled to rescind the franchise agreement when the franchisor failed to comply with the state's franchising law by not registering). *But see* Mercy Health Sys. Southeastern Pa. v. Metro. Partners Realty LLC, No. 02-1015, 2002 U.S. Dist. LEXIS 14080, at *2 (E.D. Pa. July 29, 2002) (stating that case law supports the proposition that a party may not rescind a lease agreement after the other party failed to make the required disclosures under the FTC's franchise rules).

services even if the seller's trademark is not involved. The FTC Rule and twenty-three states, including Texas, regulate business opportunities.[31] Some states have both franchising and business opportunity laws, and some have one but not the other.[32] Generally, if a business transaction is a franchise, it will be exempt from that state's business opportunity law. Business opportunity laws, however, often affect agreements drafted to avoid franchise definitions. These laws also differ materially from state to state.

F. *Texas Business Opportunity Act*

Texas regulates franchising and business opportunities through the BOA.[33] The BOA definition of "business opportunity" is broader than the FTC Rule's definition of "franchise" and "business opportunity."[34]

G. *Relationship Laws*

Arkansas, California, Connecticut, Delaware, Florida, Hawaii, Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Virginia, Washington, and

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31. ALA. CODE § 8-19-5(20) (2004); CAL. CIVIL CODE §§ 1812.200-1812.221 (Deering Supp. 2004); CONN. GEN. STAT. ANN. §§ 36-503-36.529 (West 2004); FLA. STAT. ANN. §§ 559.80-559.815 (West 2004); GA. CODE ANN. §§ 10-1-410 to 10-1-417 (Harrison 2004); 815 ILL. COMP. STAT. ANN. §§ 602/5-1 to 602/99-1 (West 2004); IND. CODE ANN. §§ 24-5-8-1 to 24-5-8-21 (West 2004); IOWA CODE ANN. §§ 523B.1-523B.13 (West 2004); KY. REV. STAT. ANN. §§ 367.801-367.809 (Michie 2004); LA. REV. STAT. ANN. §§ 51:1821-1824 (West 2004); ME. REV. STAT. ANN. tit. 32, §§ 4691 to 4700-B (West 2004); MD. CODE ANN., BUS. REG. §§ 14-101 to 14-129 (2004); MICH. COMP. LAWS ANN. §§ 445.901-445.921 (West 2004); NEB. REV. STAT. ANN. §§ 59-1701 to 59-1762 (Michie 2004); N.H. REV. STAT. ANN. §§ 358-E:1 to 358-E:6 (2004); N.C. GEN. STAT. §§ 66-94 to 66-100 (2004); OHIO REV. CODE ANN. §§ 1334.01-1334.99 (West 2004); OKLA. STAT. ANN. tit. 71, §§ 801-829 (West 2004); S.C. CODE ANN. §§ 239-57-10 to 39-57-80 (Law. Co-op. 2004); S.D. CODIFIED LAWS §§ 37-25A-1 to 37-25A-54 (Michie 2004); TEX. BUS. & COM. CODE ANN. ch. 41 (Vernon 2002); UTAH CODE ANN. §§ 13-15-1 to 13-15-7 (2004); VA. CODE ANN. §§ 59.1-262 to 59.1-269 (Michie 2004); WASH. REV. CODE ANN. §§ 19.110.010-19.110.930 (West 2004).

32. *See* Attachment A (providing an analysis of state and federal franchise laws).

33. *See generally* Business Opportunity Act, TEX. BUS. & COM. CODE ANN. ch. 41 (Vernon 1994) (providing procedures to protect persons against fraud in transactions involving business opportunities). According to the Act, 16 C.F.R. § 436 may be used to assist in the interpretation of TEX. BUS. & COM. CODE ANN. ch. 41. *Id.* § 41.002.

34. *Compare* TEX. BUS. & COM. CODE § 41.004 (Vernon 1994) (defining "business opportunity" and enumerating exceptions), *with* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,967 (Aug. 24, 1979) (explaining "package and produce franchises" and "business opportunity ventures").

Wisconsin have relationship laws that capture more distribution arrangements and require more of the seller than most business persons realize.[35] In dealing with existing dealers and franchises, one must be aware of the applicable state's relationship laws, if any. These laws legislate most-favored nation clauses,[36] regulate the "good cause" reasons a franchisee can be terminated or not renewed, dictate the notice requirements to effect a termination, and determine the effect of termination. They are not, however, within the scope of this paper.

II. "FRANCHISE" DEFINED

A. *Federal Definition of Franchising*

1. Definition

A relationship is an FTC Rule "franchise"[37] if it meets the requirements of both Section 436.2(a)(1)(i)[38] and Section 436.2(a)(2)

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35. *See generally* Colt Indus. Inc. v. Fidelco Pump & Compressor Corp., 844 F.2d 117 (3d Cir. 1988) (holding that a non-exclusive agreement with restricted use of a brand name and without a community of interest in the marketing of goods and services between a manufacturer and a distributor does not amount to a franchise under New Jersey law); Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield For Franchisors*, 45 BUS. LAW. 289 (1989) (comparing franchise relationship laws across the United States).

36. *See* Can. Dry Corp. v. Nehi Beverage Co. of Indianapolis, 723 F.2d 512, 521 (7th Cir. 1983) (discussing discrimination among franchisees).

37. *See* 16 C.F.R. § 436.2(a) (2003) (defining "franchise"). Section 436.2(a)(1)(i) franchises are technically referred to as "product franchises," while Section 436.2(a)(1)(ii) franchises are technically referred to as "business opportunity franchises." *Id.* The primary, although not only, difference between the two is that the franchisee in the product franchise uses the franchisor's mark or name while the business opportunity franchisee does not. *Compare* 16 C.F.R. § 436.2(a)(i) (2003) (defining "franchise" as, *inter alia*, a commercial relationship wherein goods or services are identified by a trademark or service mark), *with* 16 C.F.R. § 436.2(a)(ii) (2003) (applying to, *inter alia*, goods sold, offered for sale, or distributed that are supplied by another person). As product franchises are popularly called "franchises" and business opportunity franchises are popularly called "business opportunities." *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,966 (Aug. 24, 1979) (calling the two types of relationships "package and product franchises" and "business opportunity ventures"), this Article will exclusively use those terms.

38. 16 C.F.R. § 436.2(a) (2003).

> (a) The term *franchise* means any continuing commercial relationship created by any arrangement or arrangements whereby:
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> (1)(i)(A) a person (hereinafter "franchisee") offers, sells, or distributes to any person other than a "franchisor" (as hereinafter defined), goods, commodities, or services which are:

of the Code of Federal Regulations,[39] and is not otherwise exempt or excluded.[40] Unfortunately, Section 436.2(a) is written like a federal tax regulation; a novice's first attempt to wring a reliable answer from its few dozen words is often futile. It may be summarized to yield a three-part test:

(1) Does the relationship involve a *common trademark or format*?[41]
(2) Does the relationship involve *significant control or assistance* from the seller?[42] For example, the agreement might provide that only the seller's products can be sold, the seller will train the buyer to perform the service in question, or the seller will show the buyer how to market the products.[43]

(*1*) Identified by a trademark, service mark, trade name, advertising or other commercial symbol designating another person (hereinafter "franchisor"); or

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

(B)*(1)* The franchisor exerts or has authority to exert a significant degree of control over the franchisee's method of operation, including but not limited to, the franchisee's business organization, promotional activities, management, marketing plan or business affairs; or

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

Id.

39. 16 C.F.R. § 436.2(a)(2) (2003). "The franchise is required as a condition of obtaining or commencing the franchise operation to make a payment or a commitment to pay to the franchisor, or to a person affiliated with the franchisor." *Id.*

40. *See id.* § 436.2(a)(3) (providing exemptions for which the rule does not apply, including fractional franchises and certain situations where the sales occurs on the retailer-grantor's premises and for the retailor-grantor's benefit); 16 C.F.R. § 436.2(a)(4) (2003) (providing exclusions from the definition of franchise, including an employer-employee relationship, cooperatives, and certain uses of trademarks, service marks, and trade names).

41. *See id.* § 436.2(a)(1)(i)(A) (defining "franchisor" to include one who offers, sells, or distributes goods or services bearing marks that designate another person or that are directly or indirectly required to meet standards prescribed by another person when the products or services bear another's mark).

42. *See id.* § 436.2(a)(1)(i)(B) (pertaining to, but not limited to, the promotional activities, business organization, management, business affairs, or marketing plan of the "buyer").

43. *See id.* (stating that assistance with promotional activities by itself, however, does not constitute the required "significant assistance").

(3) Is there *a required payment of $500* or more to the seller or its affiliates during the first six months of the relationship?[44] In addition to a denominated franchise fee, this includes required payments for "other than reasonable quantities of wholesale goods purchased for resale," a minimum order of supplies, a required purchase of goods for more than the cost of similar goods elsewhere, or a requirement to buy services.[45]

The 2004 FTC Staff Report recommends a more intelligible definition:

> *Franchise* means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller represents, orally or in writing, that:
> (1) The franchisee obtains 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 exerts or has authority to exert a significant degree of control over the franchisee's method of operation, or provides 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.[46]

2. Distributorship Example

If you sell me an AJAX Bicycle distributorship and give me the right to be your only authorized "AJAX store" in town, then the FTC Rule's first element (a "common trademark" via the license to use the AJAX trademark and trade name) and second element ("significant assistance" via the protected territory) are met. If I

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44. *See* 16 C.F.R. § 436.2(a)(3) (2003) (exempting franchises from the provisions when the total of the payments made is less than $500).

45. *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,967 (Aug. 24, 1979) (indicating the FTC's intent to capture "hidden franchise fees," and indicating that payments at a bona fide, reasonable wholesale price will not be considered "required payments under § 436.2(a)(2)").

46. Bureau of Consumer Prot., Fed. Trade Comm'n, Disclosure Requirements and Prohibitions Concerning Franchising: Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR Part 436), attach. b at 4 (Aug. 2004), *at* http://www.ftc.gov/os/2004/08/0408franchiserulerpt.pdf.

do not pay you an up-front fee and only pay you a bona fide wholesale price for a reasonable quantity of bicycles, then the third element of the franchise definition ("required payment") is *not* met. We do *not* have a franchise relationship.

However, if (1) I have to pay you at least $500 for the privilege of being your distributor, (2) I have to purchase more bicycles from you than reasonably necessary to open my store,[47] (3) the price of bicycles to me is higher than the bona fide wholesale price for similar bicycles elsewhere,[48] or (4) I have to buy $500 of required advertising materials, a large AJAX sign, or training from you, then the third element *is* met and there *is* a "franchise." In any of these events, if you have not complied with applicable federal and state franchise law, then your sale of the AJAX franchise to me is unlawful.

This act of legal alchemy—converting a mundane business deal between fully informed, consenting business persons into an unlawful and possibly illegal act—is performed via the above definition of "franchise," which is so expansive that its parameters are most usefully presented by looking at business deals that lie just outside of those parameters.

The authorities cited in the following discussion of the FTC are FTC Final Guidelines and FTC Informal Staff Advisory Opinions, while the authorities cited concerning state statutes are court decisions. This is because there is no private cause of action under the

47. *See* Marathon Petroleum Co. v. LoBosco, 623 F. Supp. 129, 134 (N.D. Ill. 1985) (construing a similar Illinois statute to mean a franchise fee is met if a buyer is required to buy an unreasonably large quantity of goods).

48. *See* 16 C.F.R. § 436.2(a)(2)–(a)(3) (2003) (stating that in order to be considered a franchise, the franchisee is required to pay a fee, but that fees totaling less than $500 within six months of the commencement of the franchise's operations exempt the franchise from the rule); *see also* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,967 (Aug. 24, 1979) (describing hidden franchise fees, which the rule is intended to capture). This assumes the total amount one must pay in excess of the bona fide wholesale price exceeds $500. *See id.* (noting that "any payments made by a person at a bona fide wholesale price for reasonable amounts of merchandise to be used for resale" are not considered required payments within the meaning of the rule). "Reasonable amounts" means "amounts not in excess of those which a reasonable businessman normally would purchase by way of a starting inventory or supply or to maintain a going inventory or supply." *Id.*

FTC Rule,[49] but there is a private cause of action under each state statute.[50]

B. *How to Avoid Being a Federal Franchisor*

1. Avoid the Franchise Definition

a. No Common Trademark

The "common trademark" element is satisfied if the buyer is permitted to identify its business primarily under the licensor's mark or otherwise uses the mark in a manner likely to convey to the public that it is selling goods or services on behalf of the manufacturer or trademark owner.[51] This is so broadly interpreted that, in a preliminary assessment, it should be considered met if the buyer uses the licensor's mark to identify any substantial amount of commerce.[52] Ultimately, however, if the buyer's use of the trademark does not create an association between the licensor and the buyer, then likely the trademark element is not met.[53]

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49. *See supra* note 21 (discussing how no private cause of action exists under the FTC).

50. *See, e.g.*, FLA. STAT. ANN. § 559.813 (West 2004) (providing that the purchaser of a business opportunity may exercise remedies up to one year after execution of the contract); TEX. BUS. & COM. CODE ANN. § 41.302 (Vernon 1994) (providing a private remedy under the Deceptive Trade Practices-Consumer Protection Act for enforcement of the BOA).

51. *See* 16 C.F.R. § 436.2(a)(i)(A) (2003) (applying the provision to goods, commodities, or services).

52. *See* Metro All Snax, Inc. v. All Snax, Inc., [1995-1996 Transfer Binder] Bus. Franchise Guide ¶ 10,885 (D. Minn 1996) (finding, in an order denying the plaintiff's motion for summary judgment, that under the Minnesota Franchise Act, the trademark element was met although the distributor never used the mark because the distribution agreement permitted its use "to the extent necessary"); Kim v. Servosnax, Inc., 13 Cal. Rptr. 2d 422, 427-28 (Cal. Ct. App. 1992) (finding a franchisee substantially associated with the defendant's mark in spite of a contract prohibiting use of the mark and that the plaintiff did not use the defendant's mark at the plaintiff's premises); Instructional Sys., Inc. v. Computer Curriculum Corp., 614 A.2d 124, 149 (N.J. 1992) (finding the trademark element met despite that the plaintiff operated only under its own name because the Reseller Agreement permitted the plaintiff to use the defendant's name and logo); Neptune T.V. & Appliance Serv., Inc. v. Litton Microwave Cooking Prods. Div., Litton Sys., Inc., 462 A.2d 595, 599 (N.J. Super. Ct. App. Div. 1983) (finding authorization to use a party's name sufficient to create a license under the New Jersey Franchise Practices Act because it was sufficient to induce the public into the uniform acceptance that there was a connection between the parties).

53. *See* Van Groll v. Land O' Lakes, Inc., 310 F.3d 566, 570-71 (7th Cir. 2002) (finding that a franchise did not exist when the distributor's investments were for the right to use a trademark). According to the court, defining the franchise relationship in terms of trade-

> This element will be satisfied only when the franchisee is given the right to distribute goods and services which bear the franchisor's trademark, service mark, trade name, advertising or other commercial symbol ("the mark"). The most common instances occur when either the goods or services being distributed by the franchisee are associated with the franchisor's mark or when (i) the franchisee must conform to quality standards established by the franchisor with respect to the goods or services being distributed, and (ii) the franchisee operates under a name that includes, in whole or in part, the franchisor's mark.[54]

The determining factor with respect to this element should be whether the buyer had a reasonable belief that customer perception of a substantial association between the buyer and the seller would occur and that this customer perception would be valuable enough to be a material fact inducing the buyer to enter into the seller/buyer agreement.[55] Case law, however, does not provide reliable guidance on this point, both because there is not an agreed construction of this requirement and because similar facts often produce contrary holdings.[56]

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mark use protects the distributor, who might spend money promoting the trademark, in case the relationship is later terminated. *Id.* at 570. *See also* Rudel Mach. Co. v. Giddings & Lewis, Inc., 68 F. Supp. 2d 118, 121 n.1 (D. Conn. 1999) (noting that if the plaintiff fails to establish the "substantial association" prong, the issue of whether a franchise existed is moot).

54. Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,966 (Aug. 24, 1979).

55. *Cf.* Colt Indus. Inc. v. Fidelco Pump & Compressor Corp., 844 F.2d 117, 123 (3d Cir. 1988) (Rosenn, J., dissenting) (stating that a licensor might create a reasonable belief among consumers that a connection exists between the licensor and licensee any number of ways, including the performance of warranty repair services); *Instructional Sys.*, 614 A.2d at 139 (finding that an exclusive dealer was a franchisee in spite of the lack of a trademark license because the dealer's use of the trademark created a reasonable belief by the public that there was a connection between the trade name licensor and licensee, and that licensor endorsed the licensee's activity).

56. *Compare* Master Abrasives Corp. v. Williams, 469 N.E.2d 1196, 1199 (Ind. App. 1984) (holding that when a distributor sold products that were privately labeled under the manufacturer's trademark, a court could find that the distributor was substantially associated with the trademark), *with Colt Indus. Inc.*, 844 F.2d at 120 (finding that the agreement between the parties did not constitute the grant of a trademark license under New Jersey law). In *Colt Industries*, the court stated:

> The Colt-Fidelco agreement provided that Fidelco could use the Quincy name only in a limited sense and that the Quincy brand name could not be used in Fidelco's business name. . . . In our view, if this limited agreement constitutes a license to use a trademark, then any business selling a name brand product would, under New Jersey

Any substantial use by the buyer of the seller's marks creates an issue concerning whether this element is met. The only safe harbor is to contractually prohibit the buyer from using the seller's marks and to enforce the prohibition.[57] On bad facts, however, courts have held the trademark element met even if the licensee is contractually barred from using the licensor's mark.[58]

For most classes of business transactions, from selling flour to a bakery to selling breakfast to a consumer, the buyer does not use the seller's trademark in the buyer's business. For chains or other businesses that create value from name identification, however, the trademark element is hard to avoid unless deliberately decided on and ruthlessly enforced. A business does not have to be in the FTC Rule's targeted area of abuse to find the trademark element met in its transactions.

b. No Significant Assistance or Control

A seller may attempt to avoid this element by deliberately not providing the buyer with any assistance or control. While this is possible in theory, the practical reality is that almost any assistance

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law, necessarily be considered as holding a license. . . . [T]he agreement did not constitute a grant of a trademark license to Fidelco.

Id.

57. *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,966 (Aug. 24, 1979) (stating that "the supplier may avoid coverage under the rule by expressly prohibiting the use of its mark by the distributor"); *see also* Powerbrand Prods. of Va., FTC Informal Staff Advisory Opinion, 2 Bus. Franchise Guide (CCH) ¶ 6438 (May 13, 1983) (stating that express prohibition of the use of the supplier's mark by the distributor avoids coverage under the rule); Permagraphics Int'l, Inc., FTC Informal Staff Advisory Opinion, 2 Bus. Franchise Guide (CCH) ¶ 6433 (Sept. 21, 1982) (stating that because the licensing agreement at issue expressly prohibited the use of the licensor's marks, the relationship between the parties "lack[ed] one of the essential definitional elements required to establish a franchise relationship" under the rule); U.S. Marble, Inc., FTC Informal Staff Advisory Opinion, 2 Bus. Franchise Guide (CCH) ¶ 6424 (Oct. 9, 1980) (explaining that a prohibition against using a seller's marks must be expressly stated in a contract, and that the use of contractual silence is not enough).

58. *See* Kim v. Servosnax, Inc., 13 Cal. Rptr. 2d 422, 427-28 (Cal. Ct. App. 1992) (illustrating that a franchise can be found to exist although the licensor's trademark is not used by the licensee); *Instructional Sys.*, 614 A.2d at 140 (illustrating that a franchise can exist when parties share a "special relationship" as it relates to the sale of one party's products).

or control could conceivably meet the assistance or control element.[59]

> Among the significant types of controls over the franchisee's method of operation are those involving (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.
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> Among the significant types of 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.
>
> In addition to the above listed elements—the presence of any of which would suggest the existence of "significant control or assistance"—the following additional elements will, to a lesser extent, be considered when determining whether "significant" control or assistance is present in a relationship: (a) a requirement that a franchisee service or repair a product (except warranty work), (b) inventory controls, (c) required displays of goods and (d) on-the-job assistance in sales or repairs.[60]

The gist of this FTC guideline is that the control or assistance must relate to the franchisee's general method of operating its business.[61] If the assistance concerns just a few products that collectively comprise only a small portion of the buyer's business, then

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59. *See* 16 C.F.R. 436.2(a)(1)(i)(B)(2) (2003) (codifying the control element of the "franchise" definition); United States v. Technical Communications Indus., Inc., No. 85-137-CIV-7, 1986 WL 15489, at *2 (E.D.N.C. Dec. 22, 1986) (holding that the defendant met the second requirement of the franchise rule when it promised the franchisees significant assistance through marketing and training activities); *see also* Con-Wall Corp., FTC Informal Staff Advisory Opinion, 2 Bus. Franchise Guide (CCH) ¶ 6427 (Feb. 17, 1981) (stating that restricting a franchisee's operation to a specific geographical region is indicative of significant control); U.S. Solar Indus., Inc., FTC Informal Staff Advisory Opinion, 2 Bus. Franchise Guide (CCH) ¶ 6411 (Apr. 25, 1980) (stating that a commitment to train "in all technical areas," coupled with promotional assistance, would constitute "significant assistance" under the rule).

60. Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,967 (Aug. 24, 1979).

61. *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. at 49,967 (stating that "in order to be deemed 'significant' the controls or assistance must be related to the franchisee's entire *method of operation*—

such assistance will likely not be considered "significant assistance."[62] There is no bright and shining line, however, separating "enough" from "not enough" assistance or control to satisfy the "significant" assistance or control element. Fact questions are resolved by a jury.

While sellers in the FTC Rule's target area typically provide assistance or control to the buyer, many sellers outside of the target area also provide assistance to customers. Such assistance may have a negligible per-unit cost to the seller, such as providing copies of marketing or training materials, and help create happy repeat customers. If the seller licenses a trademark to the buyer, the seller should also, as a practical matter, require controls to maintain end-user goodwill and avoid trademark abandonment.[63]

c. No Required $500 Payment

Generally. Sellers can avoid one element—the requirement of a payment of $500 or more during the first six months as a condition of obtaining or commencing operations[64]—by not receiving any payments from the buyer to the seller or any affiliate during the buyer's first six months of operation other than for reasonable amounts of inventory at bona fide wholesale prices.[65]

> The Commission's objective in interpreting the term "required payment" is to capture all sources of revenue which the franchisee must pay to the franchisor or its affiliate for the right to associate with the franchisor and market its goods or services. Often, required pay-

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not its method of selling a specific product or products which represent a small part of the franchisee's business").

62. *See id.* (explaining that the control must be related to the franchisee's entire method of operation).

63. A license of a trademark which does not place sufficient controls on the licensees' use of the mark is termed a "naked license." A naked license may result in the abandonment and forfeiture of the licensor's ownership of the trademark. *See* BLACK'S LAW DICTIONARY 931 (7th ed. 1999) (defining a naked license as "[a] license allowing a licensee to use a trademark on any goods and services the licensee chooses"). No trademark licensor wants to lose its trademark rights due to insufficient controls on its licensee's use of the mark. *See generally* SIEGRUN D. KANE, TRADEMARK LAW: A PRACTITIONER'S GUIDE § 11:2:3, at 11-15 to 11-35 (3d ed. 2001) (discussing how trademarks may be voluntarily and involuntarily abandoned).

64. 16 C.F.R. § 436.2(a)(2), (3)(iii) (2003).

65. *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulations Rule, 44 Fed. Reg. at 49,967 (Aug. 24, 1979) (discussing the FTC's intent to capture all hidden franchise fees).

> ments are not limited to a simple franchise fee, but entail other payments which the franchisee is required to pay to the franchisor or an affiliate, either by contract or by practical necessity. Among the forms of required payments are initial franchise fees as well as those for rent, advertising assistance, required equipment and supplies—including those from third parties where the franchisor or its affiliate receives payment as a result of such purchases—training, security deposits, escrow deposits, non-refundable bookkeeping charges, promotional literature, payments for services of persons to be established in business, equipment rental, and continuing royalties on sales.
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> The payments may be required either by contract or by practical necessity. Payments required by contract would include not only those required by the franchise agreement, but also those required in any companion contracts which the parties may execute, such as a real estate lease. Payments made by practical necessity include, among others, those for equipment which can only be obtained, in fact, from the franchisor or its affiliate.[66]

A franchisee starts its operations when the franchisee first makes the goods or services available for sale.[67]

Notes that are subject to certain defenses and payable only after the six-month period do not count toward the threshold $500.[68] The required payment element is slightly revised in the 2004 FTC Staff Report.[69]

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66. *Id.*

67. *Id.* at 49,968.

68. *Id.*; *see also* Automobile Importers of Am., Inc., FTC Informal Staff Advisory Opinion, 2 Bus. Franchise Guide (CCH) ¶ 6382 (Aug. 9, 1979) (indicating that a promissory note payable after the six-month period is acceptable as long as the payment method does not frustrate or circumvent the rule's protections).

69. Bureau of Consumer Prot., Fed. Trade Comm'n, Disclosure Requirements and Prohibitions Concerning Franchising: Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulations Rule (16 C.F.R. Part 436), attach. b at 64 (Aug. 2004), *at* http://www.ftc.gov/os/2004/08/0408franchiseruleerpt.pdf (exempting from the proposed rule franchisors that can prove "[t]he total of the required payments, or commitments to make a required payment, to the franchisor or an affiliate that are made any time from before to within six months after commencing operation of the franchisee's business is less than $500").

Wholesale Goods Exception. Inventory payments composed of "bona fide wholesale price[s] for reasonable amounts of merchandise" are not "required payments."[70]

> Questions have been raised as to where, within the foregoing scheme, fall payments for inventory sold at a bona fide wholesale price. The Commission recognizes that it is, as a practical matter, virtually impossible to draw a clear line between start-up inventory that is purchased at the franchisee's option, and that which is purchased as a matter [of] practical or contractual necessity. In order to minimize ambiguity in this respect, but consistent with the Commission's objective that "required payment" capture all sources of hidden franchise fees, the Commission will not construe as "required payments" any payments made by a person at a bona fide wholesale price for reasonable amounts of merchandise to be used for resale. The Commission will construe "reasonable amounts" to mean amounts not in excess of those which a reasonable businessman normally would purchase by way of a starting inventory or supply or to maintain a going inventory or supply.[71]

The bona fide wholesale price exclusion only applies to "goods"; it does not apply to payments for services, fixtures, or leases. Thus, reasonable payments for training, advertising, warranty service, or on site assistance may be a franchise fee. In one case, the supplier's contention that he was merely selling at a reasonable wholesale price failed when the distributor demonstrated that a co-op contribution was required based upon the amount of the distributor's product purchases.[72] The court concluded that the cost of the co-op advertising program was an add-on to the basic wholesale price of the product, and thus comprised an indirect franchise fee.[73]

Caveat. While most business deals do not include a required payment "as a condition of obtaining or commencing the franchise

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70. *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulations Rule, 44 Fed. Reg. at 49,967 (Aug. 24, 1979) (recognizing the virtual impossibility of drawing a clear line between start-up inventory purchased at the franchisee's option and inventory purchased as a matter of practical or contractual necessity).

71. *Id.*; *see also* Flynn Beverage, Inc. v. Joseph E. Seagram & Sons, Inc., 815 F. Supp. 1174, 1179 (C.D. Ill. 1993) (holding that franchise fees were indirectly paid when the plaintiff was required to purchase excessive quantities of inventory).

72. *See* Pool Concepts, Inc. v. Watkins, Inc., [2001-2002 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 12,249, at 35,191 (Jan. 29, 2002) (finding that because the money that the defendant collected from the plaintiff was, *inter alia*, for participation in the co-op's advertising fund, the plaintiff was entitled to the state's franchise protection).

73. *Id.* at 35,191 n.2 (granting the plaintiff's motion for a preliminary injunction).

operation,"[74] many do, despite that they are not in the seller's—or anyone else's—conception of the FTC Rule's targeted area of abuse. The FTC Rule's definition was drafted to cover all perceived methods that evil franchise/worm farm/chinchilla ranch sellers and their clever lawyers might employ.[75] That it additionally covers many straight-up honest business deals is a bland statement of fact.

It is more difficult to avoid the required payment element than appears at first glance. All payments, notes, and commitments from the buyer to seller and its affiliates during the first six months need to be examined. FTC informal staff advisory opinions concerning this point should be read before relying on this method of avoidance.[76] Further, the relationship laws in Arkansas, Connecticut, Missouri, New Jersey, and Wisconsin do not contain a franchise fee element and will govern the ongoing relationship if the other definitional elements of those statutes are present.[77]

d. Other Sales Structures

Use Agents. "Agency relationships in which independent agents, compensated by commission, sell goods or services (e.g. insurance salespersons) are excluded, since there is no 'required payment.'"[78]

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74. 16 C.F.R. § 436.2(a)(2) (2003).

75. *See* H. Bret Lowell & John F. Dienelt, *Drafting Distribution Agreements*, 11 DEL. J. CORP. L. 725, 727 (1986) (noting that business opportunities are often thought of as "schemes," such as vending machine routes, earthworm farms, rabbit breeding businesses, and greenhouse flower growing businesses).

76. *See, e.g.*, Am. Motors Corp., FTC Informal Staff Advisory Opinion, 2 Bus. Franchise Guide (CCH) ¶ 6385 (Aug. 22, 1979) (illustrating that payments within the first six months must be closely examined); General Motors Corp., 2 Bus. Franchise Guide (CCH) ¶ 6384 (Aug. 17, 1979) (analyzing how payments must be investigated in the first six months).

77. ARK. CODE ANN. § 4-72-202 (Michie 2004); CONN. GEN. STAT. ANN. § 42-133e(b) (West 2004); MO. ANN. STAT. § 407.400 (West 2004); N.J. STAT. ANN. § 56:10-3 (West 2004); WIS. STAT. ANN. § 553.03 (West 2004).

78. Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,967-68 (Aug. 24, 1979); *see also* Gentis v. Safeguard Bus. Sys., Inc., 71 Cal. Rptr. 2d 122, 126-28 (Cal. Ct. App. 1998) (holding that the plaintiff's contractual inability to sell the defendant's goods was not fatal to its claim of being a California franchisee). *Contra* Cawiezell v. Franklin Life Ins. Co., No. 99-2416, 2000 U.S. App. LEXIS 33766, at *8 (4th Cir. Dec. 27, 2000) (per curium) (holding that an insurance company's sales manager was not a franchisee under Illinois law because he lacked authority to bind the company).

Established Dealerships. In traditional dealership systems, the dealer does not pay for the dealership; the dealer already has an ongoing business. He chooses to buy or not buy whatever goods he desires from the manufacturer at a wholesale price, and he may carry competitive products. He may or may not have an exclusive territory. An existing hardware store carrying several brands of lawn mowers, even if the owner has an exclusive territory for one of the lines of lawn mowers, is an example of an established dealer exempted from the FTC Rule.

Joint Ventures and Partnerships. General or limited partnerships are exempt.[79] The partnership exclusion only applies if everyone is a general partner. Few national companies, however, want to form dozens of general partnerships. The original seller will still have to enter an agreement with the new partnership entity, which may be covered by the FTC Rule. A multiplicity of limited partnerships also raises state and federal securities problems.

Equity Ownership. Some companies establish separate legal entities in different markets, and either grant the manager a minority equity interest together with a share of the profits, or simply enter into an agreement with the manager guaranteeing him or her a share of the profits. These arrangements typically provide for mandatory repurchase upon the manager's termination of his relationship with the company. However, if the manager pays for the equity or the profit sharing rights, or takes reduced compensation, both franchise and security laws may be triggered.

2. Exemptions and Exclusions

The FTC Rule exempts certain relationships that otherwise fall within the franchise definition.

a. Fractional Franchise

The FTC Rule is intended to help inexperienced buyers, not seasoned pros in that line of commerce. If the product or service purchased from the seller by the buyer is reasonably expected to account for no more than twenty percent of the buyer's dollar volume of sales, and the buyer or any of its current directors or execu-

79. *See* 16 C.F.R. § 436.2(a)(4)(i) (2003) (excluding relationships between "general business partners" from consideration as franchises).

tive officers has at least two years prior experience in the same or similar business, then the franchise sold is termed a "fractional franchise" and is exempted from coverage.[80] For example, an exclusive buying agreement between a tire manufacturer and a service station dealer would not be a franchise if the tires are less than twenty percent of the dealer's sales and the dealer has been in the business for two years. On the other hand, "[R]easonable minds may differ whether the introduction of ice cream sales at a donut/coffee shop is 'complementary.'"[81] Thus, a business can avoid franchising by only approaching established dealers and offering a product as an addition to their existing business.

While this exemption seems overly complex, in practice it covers the vast majority of business transactions.[82] Almost all of any business's sales are to buyers who continue to do what they were doing before the sale. The 2004 FTC Staff Report recommends a more precise fractional franchise definition:

> *Fractional franchise* means a franchise relationship that satisfies the following criteria when the relationship is created:
> (1) The franchisee or any of the franchisee's current directors or officers has more than two years of experience in the same type of business; and
> (2) The parties have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20 percent of the

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80. *See* 16 C.F.R. § 436.2(a)(3)(i) (2003) (exempting fractional franchises from the rule's coverage); *id.* § 436.2(h) (2003) (defining a fractional franchise).

> The term *fractional franchise* means any relationship, as denoted by paragraph (a) of this section, in which the person described therein as a franchisee, or any of the current directors or executive officers thereof, has been in the type of business represented by the franchise relationship for more than 2 years and the parties anticipated, or should have anticipated, at the time the agreement establishing the franchise relationship was reached, that the sales arising from the relationship would represent no more than 20 percent of the sales in dollar volume of the franchisee.

Id.; *see also* Kinetic Indus. Corp., FTC Informal Staff Advisory Opinion, 2 Bus. Franchise Guide (CCH) ¶ 6440 (Aug. 19, 1983) (explaining that the fractional franchise exemption would apply in circumstances "where an established distributor adds a franchised product line to its existing line of goods").

81. Bureau of Consumer Prot., Fed. Trade Comm'n, Disclosure Requirements and Prohibitions Concerning Franchising: Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR Part 436), 34 (Aug. 2004), *at* http://www.ftc.gov/os/2004/08/0408franchiserulerpt.pdf.

82. *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, at 44 Fed. Reg. 49,968 (indicating the rule is not intended to cover established businesses that are merely extending their product line).

franchisee's total dollar volume in sales during the first year of operation.[83]

b. Other Exemptions

Leased Department. This exemption applies when an independent retailer sells its own goods and services from premises leased from a larger retailer in the larger retailer's store.[84] For example, ABC Department Store grants a license to Florsheim Shoes, Inc., to sell footwear in a portion of the ABC Department Store. This exemption is not applicable, however, if the retailer must purchase its goods or services from suppliers required or approved by the department store.[85]

Oral Agreements. A sale is exempt "[w]here there is no writing which evidences any material term or aspect of the relationship or arrangement."[86] This is strictly construed: Even a purchase invoice is considered to include material terms.

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83. Bureau of Consumer Prot., Fed. Trade Comm'n, Disclosure Requirements and Prohibitions Concerning Franchising: Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR Part 436), attach. b at 4 (Aug. 2004), *at* http://www.ftc.gov/os/2004/08/0408franchiserulerpt.pdf.

84. *See* 16 C.F.R. § 436.2(a)(3)(ii) (2003) (exempting certain agreements created by lease, license, or similar agreement).

> Where pursuant to a lease, license, or similar agreement, a person offers, sells, or distributes goods, commodities, or services on or about premises occupied by a retailer-grantor primarily for the retailer-grantor's own merchandising activities, which goods, commodities, or services are not purchased from the retailer-grantor or persons whom the lessee is directly or indirectly (A) required to do business with by the retailer-grantor or (B) advised to do business with by the retailer-grantor where such person is affiliated with the retailer-grantor . . . .

Id. The 2004 FTC Staff Report Proposed Rule is more user–friendly:

> *Lease department* means 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: (1) the retailer; (2) a person the retailer requires the seller to do business with; or (3) a retailer-affiliate if the retailer advises the seller to do business with the affiliate.

Bureau of Consumer Prot., Fed. Trade Comm'n, Disclosure Requirements and Prohibitions Concerning Franchising: Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 C.F.R. Part 436), attach. b at 5 (Aug. 2004), *at* http://www.ftc.gov/os/2004/08/0408franchiserulerpt.pdf.

85. *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. at 49,968 (Aug. 24, 1979) (defining "leased departments" within the meaning of the Rule).

86. 16 C.F.R. § 436.2(a)(3)(iv) (2003).

Employer/Employee Relationships. Employment relationships are exempt.[87] Courts use the traditional "right of control" test to determine whether an employment relationship exists. Factors include whether a salary is paid, whether the employee can be discharged without further liability on the part of the principal, and whether the employee must invest any money before being hired.[88]

Miscellaneous. Also exempt are certain retailer and agricultural cooperatives.[89] The Rule excludes groups that license their mark to anyone who complies with a standard and pays the fee (e.g., Underwriters Laboratories, which licenses permission to use "UL" on products that meet its standards).[90] The license of a trademark to only one licensee is exempt.[91] The Rule also excludes collateral product licensing.[92] For example, a license of the Coca-Cola mark for use on T-shirts or a license issued as a result of trademark infringement litigation is exempt.[93]

The 2004 FTC Staff Report recommends including three sophisticated investor exemptions, which would more closely align the Rule with existing federal securities regulations.[94] The proposed exemptions include a large investment exemption, which would include transactions in which the franchisees often demand and receive information in great quantities and detail that already exceeds the Rule's disclosure requirements.[95] In addition, the pro-

87. *See* 16 C.F.R. § 436.2(a)(4)(i) (2003) (excluding "[t]he relationship between an employer and an employee").

88. *See* RESTATEMENT (SECOND) OF AGENCY § 220 (1958) (enumerating the traditional questions of fact that help determine whether a person is acting as a servant of another).

89. *See* 16 C.F.R. § 436.2(a)(4)(ii) (2003) (excluding membership in bona fide cooperative associations).

90. *See* 16 C.F.R. § 436.2(a)(4)(iii) (2003) (excluding from the Rule licensing for purposes of evaluation, testing, or certification of goods and services).

91. *See* 16 C.F.R. § 436.2(a)(4)(iv) (2003) (excluding "[a]n agreement between a licensor and a single licensee").

92. Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,969 (Aug. 24, 1979).

93. *See id.* (excluding collateral product licensing and licensing agreements resulting from trademark infringement litigation).

94. Bureau of Consumer Prot., Fed. Trade Comm'n, Disclosure Requirements and Prohibitions Concerning Franchising: Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR Part 436), 231 (Aug. 2004), *at* http://www.ftc.gov/os/2004/08/0408franchiserulerpt.pdf.

95. *Id.* at 235.

posed exemptions include a large corporate-franchisee exemption and an exemption for officers and owners.[96]

3. Do Not Misuse the Term "Franchise"

A distributorship in which the seller offers the buyer significant assistance and "which is represented either orally or in writing to be a franchise" is deemed a franchise subject to the FTC Rule.[97] The term "franchise" should be deleted from all sales literature, correspondence, and agreements if you do not want the relationship to be considered a franchise.

C. *State Definitions of Franchising*

1. In General

Fifteen states regulate franchise sales.[98] Because none of these state statutes are identical, each must be separately examined to see if your client's method of doing business is covered in the subject state.

Because of the lack of a federal private cause of action for violating the FTC Rule[99] and the FTC's lack of resources to pursue isolated complaints, a well-intentioned but non-compliant seller is more likely to come to grief because of a buyer or state regulator asserting that the seller is violating a state law rather than failing to comply with the FTC Rule. The FTC generally limits itself to pursuing bad actors rather than legitimate businesses that promise to comply with the Rule in the future.

To reduce conflicts between state franchise laws, the North American Securities Administrators Association (NASAA) created, and has periodically revised, a Uniform Franchise Offering Circular (UFOC).[100] Nevertheless, the states are not entirely uni-

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96. *Id.* at 245, 249.

97. 16 C.F.R. § 436.2(a)(5) (2003).

98. *See supra* note 27 (listing the states that require notice filing or registration, and disclosure before offering a franchise for sale); *see also* Attachment A (providing additional analysis of state and federal law).

99. *See supra* note 21 (indicating that the FTC does not recognize a private cause of action).

100. *See* N. Am. Sec. Admin. Ass'n, The Uniform Franchise Offering Circular Guidelines, item 90 (2000), *available at* http://www.nasaa.org/nasaa/scripts/fu_display_list.asp?ptid=34 (describing that the NASAA and its predecessor prepared and adopted the UFOC); FTC Approves New UFOC Earnings Claims, Franchise Identity Rules, [June 1996-Sept.

form in UFOC format and other requirements, which adds a maddening layer of delay, details, and expense to the compliance process.[101]

2. "Marketing Plan" Definition

a. Definition

California, Illinois, Indiana, Maryland, Michigan, New York, North Dakota, Oregon, Rhode Island, Virginia, Washington, and Wisconsin generally define a "franchise" as:

> A contract or agreement, either express or implied, whether oral or written, between two or more persons by which:
> (1) a franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a *marketing plan* or system prescribed ("or suggested" in some states) in substantial part by a franchisor; and
> (2) the operation of the franchisee's business pursuant to such plan or system substantially associated with the franchiser's *trademark*, service mark, trade name, logo, advertising, or other commercial symbol designating the franchiser's affiliate; and
> (3) the franchisee is required to pay, directly or indirectly, a *franchise fee*.[102]

b. "Marketing Plan"

The marketing plan element encompasses relationships that are not commonly thought of as being a franchise. Whether a marketing plan exists is very much in the eye of the beholder. A seller's advertising claims that it has a successful marketing plan, uniformity of marketing, controls on the purchaser's sale of competitive

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1987 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 8862, at 17,697 (1987) (describing the 1986 adoption by the NASAA of items 19 and 20 of the UFOC).

101. *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,970-71 (Aug. 24, 1979) (indicating that the commission determined that the UFOC disclosure requirements provide protection equal to or greater than that of the Rule). While the FTC Rule preempts the UFOC, the FTC authorizes use of the UFOC with certain exceptions. *Id.* at 49,971. A franchisor can choose to use the FTC format in states that do not specifically require the UFOC. The FTC format generally requires less disclosure, particularly for a new franchisor. *See id.* at 49,970 (indicating that the commission determined that the UFOC disclosure requirements provide protection equal to or greater than that of the rule).

102. This definition is for discussion purposes only. The specific statute of each state must be reviewed. *See supra* note 27 (providing a list of the specific statutes).

and non-competitive goods, operations or training manuals, and requirements that the buyer purchase goods from approved sources will be considered by the state administrator or local jury when determining whether the particular relationship has the requisite "marketing plan."[103]

A marketing plan may be prescribed by implication.[104] Giving marketing suggestions to a buyer may be a "marketing plan . . . prescribed" even if the agreement explicitly states that the buyer is not required to follow the suggestions.[105]

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103. *See generally* When Does an Agreement Constitute a "Franchise"?, Cal. Dep't of Corps. Release 3-F (Revised) (June 22, 1994), *available at* http://www.corp.ca.gov/commiss/rel3f.htm (indicating that for an agreement to constitute a franchise under California's Franchise Investment Law, "the business in which the franchisee is granted the right to engage in must be operated under a marketing plan or system prescribed in substantial part by the franchisor"). There are numerous conflicting cases concerning when marketing assistance by a seller does or does not comprise a "marketing plan." *See, e.g.*, Jerome-Duncan, Inc. v. Auto-By-Tel, L.L.C., 176 F.3d 904, 910 (6th Cir. 1999) (finding that an agreement for online services did not prescribe a "marketing plan" under Michigan law); Hoosier Penn Oil Co. v. Ashland Oil Co., 934 F.2d 882, 885-86 (7th Cir. 1991) (rejecting the plaintiff's arguments that, *inter alia*, a minimum purchase requirement and the defendant's designation of the plaintiff's primary sales area were sufficient to bring the parties' relationship under the definition of a franchise); Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128, 134-35 (7th Cir. 1990) (concluding that a quota of copiers to sell, a national territory, and mandatory training before allowing personnel to sell copiers was sufficient to establish a marketing plan); Gross v. IBM Corp., No. N-88-196 (WWE), 1990 U.S. Dist. LEXIS 11579 (D. Conn. July 30, 1990) (indicating marketing assistance from IBM was not enough to be considered a "prescribed marketing plan"); Blankenship v. Dialist Int'l Corp. 568 N.E.2d 503, 506-07 (Ill. App. Ct. 1991) (believing certain representations sufficient to meet the statutory requirement of a marketing plan). In *Blankenship*, the plaintiff received a detailed explanation of the defendant's system and was promised additional instruction at a later date. *Id.* at 506. The plaintiff was also furnished with a manual detailing the defendant's products, and received personal assistance from the defendant's president when the plaintiff encountered credibility issues concerning the defendant. *Id.* at 506-07.

104. *See* When Does an Agreement Constitute a "Franchise"?, Cal. Dep't of Corps. Release 3-F (Revised) I.B.2.(e) (June 22, 1994), *available at* http://www.corp.ca.gov/commiss/rel3f.htm (indicating when a marketing plan might be prescribed by implication).

> A marketing plan or system may be "prescribed" . . . where a specific sales program is outlined, suggested, recommended, or otherwise originated by the franchisor. Thus, a sales program may be "prescribed" by the franchisor where the franchisor supplies the franchisee with sales aids or props, such as demonstration kits, films, or detailed instructions for personal introduction and presentation of the product, possibly including the text of a sales pitch and especially where such a program is supported by training material, courses, or seminars.

Id.

105. *See* ILL. ADMIN. CODE tit. 14 § 200.102(c) (2004) (indicating that "[a] marketing plan or system may be prescribed or suggested in substantial part . . . notwithstanding

c. "Trademark"

This element is similar to the federal element discussed above.[106]

d. "Franchise Fee"

The requisite "franchise fee" ranges from zero for New York[107] to the standard $500, and all points in between. The FTC Rule's six-month limitation on counting monies to be applied to this element is not present in most state statutes.[108]

A "franchise fee" is typically defined as "any fee or charge that a franchisee . . . is required to pay or agrees to pay directly or indirectly for the right to enter into a business under a franchise agree-

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provisions of a franchise or other agreement purporting to grant the franchisee complete freedom in operating its business"); When Does an Agreement Constitute a "Franchise"?, Cal. Dep't of Corps. Release 3-F (Revised) I.B.2.(e) (June 22, 1994), *available at* http://www.corp.ca.gov/commiss/rel3f.htm (explaining that a provision in an agreement that the franchisor is not concerned with franchisee's means to make sales does not preclude the possibility that the business is operated according to a marketing plan or system). *Compare* In the Matter of The KIS Corp., Wis. Comm'r of Sec File No. F-86008(E), [June 1986-Sept. 1987 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 8731, at 17,085-87 (Dec. 24, 1986) (indicating that mere suggestions are not a "prescribed" plan under the Wisconsin Franchise Investment Law), *with* Seller of Photographic Minilabs to Pay Consumer Redress to Settle FTC Court Action, [Sept. 1987-Feb. 1989 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 9269 (1988) (indicating that KIS Corp. agreed its plan violated the FTC Rule and to pay $1.55 million in damages). *See also* Vaughn v. Digital Message Sys. Corp., No. 96-CV-70533-DT, 1997 U.S. Dist. LEXIS 2798, at *13-14 (E.D. Mich. Mar. 10, 1997) (indicating that a marketing plan is prescribed when the licensors tells the licensees "the best way" to recruit and train people to market the products); P & W Supply Co., v. E.I. DuPont de Nemours & Co., No. 89 C 20293, 1991 U.S. Dist. LEXIS 20552, at *4-5 (N.D. Ill. Sept. 17, 1991) (noting that the statute in question included doing business pursuant to a marketing plan "substantially suggested by the franchisor" as an element of a franchise under Illinois law); Salkeld v. V.R. Bus. Brokers, 548 N.E.2d 1151, 1155 (Ill. App. Ct. 1989) (quoting the Illinois Franchise Disclosure Act) (including in the elements of a franchise that the buyer is granted the right to engage in business under a marketing plan "prescribed or suggested in substantial part by a franchisor"); People v. Kline, 168 Cal. Rptr. 185, 188 (Ca. Ct. App. 1980) (indicating that a franchise marketing plan may be expressed or implied).

106. *See* 16 C.F.R. § 436.2(a)(i)(A)(1) (2003) (including within the definition of a franchise when goods, commodities, or services are identified by a commercial symbol designating another person).

107. N.Y. GEN. BUS. LAW § 681.3 (McKinney 2004) (failing to indicate a minimum franchise fee amount).

108. *Compare* 16 C.F.R. § 436.2(a)(3)(iii) (2003) (exempting those fees paid outside a six-month window from meeting the franchise fee element), *with, e.g.*, CAL. CORP. CODE § 31005 (Deering Supp. 2004) (failing to specify a time period as part of the franchise fee element); N.Y. GEN. BUS. LAW § 681.3 (McKinney 2004) (declining to provide a time requirement).

ment."[109] In addition to denominated franchise fees, other payments, such as payments for inventory, construction, training displays, or services, may also meet this definition.[110] On the other hand, the term "franchisee fee" does have outer limits, and lack of a franchise fee payment defeats the assertion of a franchise statute.[111]

The cautious seller's attorney and creative buyer's attorney will examine all payments made by the buyer to find all monies paid to the seller or its affiliates that may, as a practical matter, have been necessary for the buyer to enter into the business. This search will not be limited to checking the written agreement or clearly labeled requirements that a "franchise fee" be paid. Rent payments, lease payments, or service or training fees paid to the seller or its affiliates may or may not comprise a franchise fee.[112] The courts typically deem initial payments for manuals, displays, or other

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109. N.Y. GEN. BUS. LAW § 681.7 (McKinney 2004) (defining "franchise fee").

110. *See* Boat & Motor Mart v. Sea Ray Boats, Inc., 825 F.2d 1285, 1289-90 (9th Cir. 1987) (discussing whether the plaintiff paid a franchise fee and noting that "a payment to a manufacturer for goods or services may contain a hidden franchise fee when the price includes an overcharge"); Wright-Moore Corp. v. Ricoh Corp., 794 F. Supp. 844, 859 (N.D. Ind. 1991) (failing to find that the plaintiff presented enough evidence to support that it paid a franchise fee), *aff'd*, 980 F.2d 432 (7th Cir. 1992). In *Wright-Moore*, the plaintiff claimed it was required to pay indirect franchise fees by incurring various costs associated with training programs. *Id.* at 855. The plaintiff also claimed it was forced to pay a hidden franchise fee by being required to carry excess inventory. *Id.* at 850. *See also* ILL. ADMIN. CODE tit. 14 § 200.106(c) (2004) (stating that "[p]ayments for services are presumed to be in part for the right granted to the franchisee to engage in the franchise business"); When Does an Agreement Constitute a "Franchise"?, Cal. Dep't of Corps. Release 3-F (Revised) I.B.2.(e) (June 22, 1994), *available at* http://www.corp.ca.gov/commiss/rel3f.htm (explaining that "while a truly optional payment is not a franchise fee, a payment by a franchisee, though nominally optional, may in reality be essential . . . especially . . . if the franchisor intimates or suggests that the payment is essential for the successful operation of the business").

111. *See* Corporate Res. v. Eagle Hardware & Garden, Inc., 62 P.3d 544, 548 (Wash. Ct. App. 2003) (refusing to characterize profit margin as a franchise fee within the meaning of the Washington Franchise Investment Protection Act).

112. *See* Duro-Last Roofing Inc. v. Mayle, No. 99-1041, 2000 U.S. App. LEXIS 30446, at *3-4 (6th Cir. Sept. 13, 2000) (unpublished opinion) (concluding that, although the plaintiff paid a fee for technical assistance, the plaintiff was not required to pay a training fee); Hogin v. Barnmaster, Inc., No. C3-02-1880, 2003 WL 21500044, at *4-5 (Minn. Ct. App. July 1, 2003) (unpublished opinion) (affirming the trial court's conclusion that a distribution agreement was not a franchise because the right to enter the relationship with the defendant was not predicated on payment of the training fee).

promotional materials as franchise fees.[113] If a trademark license requires the licensee to pay a license fee, such payment may satisfy the franchise fee element.

"Inventory payments" composed of bona fide wholesale prices for reasonable quantities of inventory are not a franchise fee in most states.[114] If the distributor/licensee buys goods from a seller at a price higher than a "bona fide wholesale price," however, the purchase price will be deemed to be a franchise fee.[115] The FTC Rule and its Final Guides are persuasive on this point.

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113. *See* To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc., 152 F.3d 658, 663-64 (7th Cir. 1998) (indicating that Illinois law does not require that a franchise fee be collected up front, the fee need not be definite in amount, and may be indirect). In *To-Am*, the court affirmed the lower court's opinion that a dealer's purchase of $1600 of sales and service manuals over an extended period qualified as a "franchise fee." *Id.* at 666.

114. *See, e.g.*, McLane v. Pizza King Franchises, Inc., No. S 356-86, 1987 WL 92061, at *8-9 (Ind. Super. Sept. 4, 1987) (finding that the purchase price paid for wholesale pizza supplies was a bona fide wholesale price, not a franchise fee, under the Indiana Franchise law); Am. Parts Sys., Inc. v. T & T Auto., Inc., 358 N.W.2d 674, 677 (Minn. Ct. App. 1984) (holding that neither a requirement that T & T maintain a representative supply of parts nor the requirement that it keep an inventory amount equal to its loan balance were a franchise fee). When determining whether a possible franchisee purchased goods at a bona fide wholesale price, Maryland and Wisconsin examine (1) whether the consideration is purely for the purchase of goods, not reflecting payment for the right to continue such purchases; (2) whether the purchase is only allowed and not required by the parties' agreement; and (3) whether the cost of goods to the manufacturer is reasonably related to the price paid by the distributor, taking into account representative circumstances in the market of both manufacturer and distributor. MD. REGS. CODE tit. 2 § 02.10.0(C) (2004); WIS. ADMIN. CODE § DFI-Sec 31.01(7) (2004). A negative answer to any of these considerations indicates that the payment was not at a bona fide wholesale price and thus is a franchise fee.

115. *See* Grandpa Carl's Int'l, Inc., Wis. Comm'r of Sec. Advisory Interpretation, [Aug. 1990-May 1992 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 9911, at 22,656 (Mar. 21, 1991) (concluding, for two arrangements, that the franchise fee element was met where the wholesale price of the product and the fair market value of supplies and fixtures totaled less than fifty percent of the total price paid to enter the arrangements); Ramm Foods, Inc., Wis. Comm'r of Sec. Advisory Interpretation, [Aug. 1990-May 1992 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 9912, at 22,658 (Aug. 20, 1991) (concluding that the franchise fee element was met when the wholesale cost of product represented only $7500 of the $50,000 paid); US Mac Corp. v. Amoco Oil Co., [2000-2001 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 11,963, at 33,658 (Ca. Ct. App. 2000) (concluding that only evidence not before the court could establish whether a distributor agreement that set a price equal to "Amoco's established distributor book price minus the discount of $.37 per United States gallon" exceeded the bona fide wholesale price, and thus whether that price constituted a hidden franchise fee).

3. "Community of Interest"

a. Definition

Hawaii, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, South Dakota, and Wisconsin use "community of interest" to define the scope of their franchise or dealership relationship laws.[116] Hawaii, Minnesota, and South Dakota define a "franchise" as:

> A contract or agreement, either express or implied, whether oral or written, between two or more persons:
> (1) by which a franchisee is granted the right to engage in the business of offering or distributing goods and services using the franchiser's *trade name*, *trademark*, *service mark*, *logo type*, *advertising*, *or other commercial symbol* or related characteristic;
> (2) in which the franchiser and franchisee have *a community of interest* in the marketing of goods or services at wholesale, retail, by lease, by agreement, or otherwise; and
> (3) for which the franchisee pays, directly or indirectly, *a franchise fee*.[117]

Wisconsin's Fair Dealership law defines "community interest" as a "continuing financial interest between the grantor and grantee in either the operation of the dealership business or the marketing of such goods and services."[118]

"Community of interest" is slowly being defined by the courts. Courts initially held this element met if the parties had a continuing financial interest and interdependence in the operation of the distributor's business, such as when the manufacturer's profits depend on the volume of the distributor's sales and the relationship is expected to be lengthy and encompass a substantial part of the dealer's time and resources.[119] These terms have been subse-

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116. HAW. REV. STAT. ANN. § 482E-2 (Michie 2002); MINN. STAT. ANN. § 80C.01 Subd. 4. (West Supp. 2004); MISS. CODE ANN. § 75-24-51(6) (1999); MO. ANN. STAT. § 407.400(1) (West 2001); NEB. REV. STAT. ANN. § 87-402(1) (Michie 1999); N.J. STAT. ANN. § 56:10-3(a) (West 2001); S.D. CODIFIED LAWS § 37-5A-1 (Michie 2004); WIS. STAT. ANN. § 135.02 (West 2001). *See generally* Kevin M. Jones, *A Jurisdictional Survey of Community of Interest Franchise States*, DISTRIBUTION: A NEWSLETTER (Franchise and Dealership Comm., Antitrust Section–Am. Bar. Ass'n, Chicago, Ill.), May 2004, at 13 (reviewing cases from the community of interest states).

117. This definition is for discussion purposes only. The specific statute of each state must be reviewed.

118. WIS. STAT. ANN. § 135.02(1) (West 2001).

119. *See* Cassidy Podell Lynch, Inc. v. Snydergeneral Corp., 944 F.2d 1131, 1141-43 (3d Cir. 1991) (considering the factor of "economic dependence" during "community of inter-

quently further judicially defined as (1) a "continuing financial interest, that is a shared financial interest in the operation of the dealership, and (2) interdependence, that is the degree to which the dealer and grantor cooperate, coordinate their activities and share common goals in their business relationship."[120]

New Jersey, however, has a more specific definition. That state's courts find a community of interest "when the terms of the agreement between the parties or the nature of the franchise business requires the licensee, in the interest of the licensed business's success, to make a substantial investment in goods or skill that will be of minimal utility outside the franchise."[121] For example, if (1) the distributor's investments are "substantially franchise-specific," and (2) the distributor had to make these investments by agreement or the nature of the business, a court could find a community of interest.[122]

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est" analysis). The court referenced the New Jersey Superior Court's reasoning from *Neptune T.V.*, which indicated that the community of interest signaling a franchise relationship "is based on the complex of mutual and continuing advantages which induce[s] the franchisor to reach his ultimate consumer through entities other than his own which, although legally separate, are nevertheless *economically dependent* on him." *Id.* at 1141 (emphasis added).

120. Satellite Communications Co. v. Motorola, Inc., No. 03-0996, 2004 WL 57390, at *1 (Wis. App. Jan. 14, 2004) (citing Ziegler v. Rexnord, Inc., 407 N.W.2d 873 (Wis. 1987)). "[A] substantial financial investment distinguishes a dealership from a typical vendor-vendee relationship. The typical vendee makes little or no investment except for inventory. If the relationship with its vendor is terminated, the vendee suffers only a loss of future profits unless its inventory is unsalable." *Id.* at *2 (quoting Guderjohn v. Loewen Am., Inc., 507 N.W.2d 115, 120 (Wis. Ct. App. 1993)); *see also* Kayser Ford, Inc. v. N. Rebuilders, Inc. 760 F. Supp. 749, 754 (W.D. Wis. 1991) (finding no community of interest where the plaintiff's purchase of the defendant's products comprised less than two percent of the plaintiff's receipts); Lakefield Tel. Co. v. N. Telecom, Inc., 656 F. Supp. 813, 817 (E.D. Wis. 1987) (finding a community of interest in the business relationship based on the parties' customer and financial interactions); Kusel Equip. Co. v. Eclipse Packaging Equip. Ltd., 647 F. Supp. 80, 81-82 (E.D. Wis. 1986) (finding no community of interest where only two percent of a dealer's sales were derived from the grantor's products).

121. *See* Cooper Dist. Co. v. Amana Refrigeration, Inc., 63 F.3d 262, 269 (3d Cir. 1995) (relying on the New Jersey Supreme Court's interpretation); Instructional Sys., Inc. v. Computer Curriculum Corp, 614 A.2d 124, 142 (N.J. 1992) (quoting Cassidy Podell Lynch, Inc. v. Snydergeneral Corp., 944 F.2d 1131, 1134 (3d Cir. 1991)).

122. *See Cooper*, 63 F.3d at 269 (relying on New Jersey case law); Colt Indus., Inc. v. Fidelco Pump & Compressor Corp., 844 F.2d 117, 120-21 (3d Cir. 1988) (finding a lack of a community of interest because the franchise-specific investments were "suggested, not required").

There is less certainty of definition in other states.[123]

b. Illustrative "Community of Interest" Cases

A sampling of community of interest cases is illustrative.

Missouri. In *C & J Delivery, Inc. v. Emery Air Freight Corp.*,[124] C & J transported packages from Emery's facility to the recipient.[125] Emery paid C & J a fixed fee based on package size and weight.[126] The court concluded there was a community of interest because each party's success was dependent on the other party's efforts.[127]

Minnesota. In *Unlimited Horizon Marketing, Inc. v. Precision Hub, Inc.*,[128] a distributor agreed to sell a manufacturer's machines.[129] The court found a community of interest because both parties profited from the common source—the ultimate buyer of the machines—upon the distributor's sales of the machines.[130]

In *Martin Investors, Inc. v. Vander Bie*,[131] the defendant received one percent of the proceeds from loans placed by the plaintiff using the defendant's computer services.[132] The court agreed with the

123. Some states may have little or no statutory or judicial guidance. *See* Walker v. U-Haul Co. of Miss., 734 F.2d 1068, 1075 (5th Cir. 1984) (noting that as recently as 1984, the Mississippi courts had not interpreted the state's franchise statute). For one of the few cases discussing the Nebraska Franchise Practices Act, see *Home Pest & Termite Control, Inc. v. Dow Agrosciences*, L.L.C., No. 8:02CV406, 2004 U.S. Dist. LEXIS 1654, at *1 (D. Neb. Feb. 6, 2004) (failing to find a franchise where no "franchise fee" within the meaning of the statute was paid).

124. 647 F. Supp. 867 (E.D. Mo. 1986).

125. C & J Delivery, Inc. v. Emery Air Freight Corp., 647 F. Supp. 867, 868 (E.D. Mo. 1986).

126. *Id.* at 869.

127. *Id.* at 872. "Missouri courts would interpret 'community of interest' to mean, at a minimum, either (1) the franchisor benefits from the franchisee's marketing of the franchisor's product or service, or (2) the franchisee benefits from the franchisor's marketing of the product or service." *Id.*; *see also* Am. Bus. Interiors, Inc. v. Haworth, Inc., 798 F.2d 1135, 1139-40 (8th Cir. 1986) (applying Missouri law and recognizing that a community of interest existed where the defendant profited from the plaintiff's sales of the defendant's products).

128. 533 N.W.2d 63 (Minn. Ct. App. 1995).

129. Unlimited Horizon Mktg., Inc. v. Precision Hub, Inc., 533 N.W.2d 63, 65 (Minn. Ct. App. 1995)

130. *See id.* at 66 (concluding that a community of interest existed because "the parties will each profit from a common source upon the marketing and sale of the [manufacturer's product]").

131. 269 N.W.2d 868 (Minn. 1978).

132. Martin Investors, Inc. v. Vander Bie, 269 N.W.2d 868, 870 (Minn. 1978).

trial court that there was a community of interest because both parties shared in fees from a common source: the borrower.[133]

New Jersey. In *Beilowitz v. General Motors Corp.*,[134] a distributor's purchase of General Motors auto parts had value only if he continued to distribute the manufacturer's goods.[135] The court concluded that there was a community of interest between the parties.[136]

In *Instructional Systems, Inc. v. Computer Curriculum Corp.*,[137] the appellant agreed to resell the respondent's products.[138] Instructional Systems purchased office space, specialized computers, and computer upgrades to sell Computer Curriculum's products.[139] The court concluded that the trial court did not err when finding that the relationship was a community of interest.[140]

Wisconsin. In *Ziegler Co. v. Rexnord, Inc.*,[141] Ziegler agreed to distribute Rexnord's rock crushing equipment for three years.[142]

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133. *See id.* at 874-75 (rejecting the defendant's contention that one percent of loan proceeds was not substantial enough to create a community of interest).

134. 233 F. Supp. 2d 631 (D.N.J. 2002).

135. *See* Beilowitz v. Gen. Motors Corp., 233 F. Supp. 2d 631, 638 (D.N.J. 2002) (noting that both the plaintiff and defendant concluded the plaintiff would not be able to stay in business without his distributorship).

136. *Id.* at 641-42.

137. 614 A.2d 124 (N.J. 1992), *partial summary judgment granted*, 826 F. Supp. 831 (D.N.J. 1993), *aff'd in part and rev'd in part*, 35 F.3d 813 (3d Cir. 1994).

138. Instructional Sys., Inc. v. Computer Curriculum Corp., 614 A.2d 124, 126 (N.J. 1992), *partial summary judgment granted*, 826 F. Supp. 831 (D.N.J. 1993), *aff'd in part and rev'd in part*, 35 F.3d 813 (3d Cir. 1994).

139. *Id.* at 144.

140. *Id. But see* Instructional Sys., Inc. v. Computer Curriculum Corp., 826 F. Supp. 831, 855 (D.N.J. 1993), *aff'd in part and rev'd in part*, 35 F.3d 813 (3d Cir. 1994) (granting partial summary judgment in favor of Computer Curriculum Corp. based on a conclusion that the franchise law violated the Commerce Clause). The district court concluded that if the New Jersey franchise law were to be applied as advocated by ISI, such application would have a direct effect on interstate commerce by prohibiting transactions between non-New Jersey residents occurring entirely outside of New Jersey and thus concluded that such "extraterritorial application" of the act was a per se violation of the Commerce Clause. *Id.* at 845-46. The Third Circuit, however, found no conflict between the New Jersey Franchise Law and the Commerce Clause. That the franchise law would have extraterritorial effects, the court reasoned, is inevitable. Instructional Sys., Inc. v. Computer Curriculum Corp., 35 F.3d 813, 825 (3d Cir. 1994). Instead, the court concluded that Computer Curriculum Corporation's objection related more to New Jersey's implementation regarding choice of law, and found no facial conflict between the franchise statute and the Commerce Clause. *Id.* at 826.

141. 407 N.W.2d 873 (Wis. 1987).

142. Ziegler Co. v. Rexnord, Inc., 407 N.W.2d 873, 875-76 (Wis. 1987).

Rexnord's products accounted for up to eight percent of Ziegler's revenue.[143] The court remanded, determining that the trial and appeals courts failed to examine all aspects of the business relationship and instead relied only on one factor—the percentage of Ziegler's revenues generated by sales of Rexnord products.[144]

In *Satellite Communications Co. v. Motorola, Inc.*,[145] the plaintiff distributed Motorola's cell phones.[146] Motorola cancelled its distribution agreement with the plaintiff because the plaintiff failed to meet Motorola's sales goals.[147] The court held that neither of the guideposts that establish a community of interest in Wisconsin were met.[148] First, Satellite did not establish a "continuing financial interest," the first guidepost, because Satellite did not receive its main source of revenue from Motorola, and Satellite did not "make expenditures for facilities, equipment or training that w[ould] be lost as a result of the termination of the agreement."[149] Second, Satellite did not establish "interdependence," the second guidepost, simply by asserting that it had developed goodwill for Motorola's products.[150]

4. Other Definitions

In Arkansas, a license to use a trademark or distribute goods or services in an exclusive territory is a franchise even if a franchise fee is not required.[151] Delaware franchise law applies to purchas-

143. *Id.* at 876.

144. *See id.* at 882 (reflecting on the court's inability to resolve the existence of a community of interest at the summary judgment stage because of the remaining issues of fact in dispute).

145. No. 03-0996, 2004 WL 57390, at *1 (Wis. App. Jan. 14, 2004).

146. Satellite Communications Co. v. Motorola, Inc., No. 03-0996, 2004 WL 57390, at *1 (Wis. App. Jan. 14, 2004).

147. *Id.*

148. *See id.* at *2-3 (identifying the guideposts and indicating why Satellite failed to meet them).

149. *Id.* at *2.

150. *See id.* (stating that "goodwill is only one facet bearing on whether interdependence exists").

151. *See* ARK. CODE ANN. § 4-72-202(1)(A) (Michie 2001) (defining a franchise as "a written or oral agreement for a definite or indefinite period in which a person grants to another person a license to use a trade name, trademark, service mark, or related characteristic within an exclusive or nonexclusive territory"); ARK. CODE ANN. § 4-72-203 (Michie 2001) (indicating applicability of the Act); JRT, Inc. v. TCBY Sys., Inc., [Dec. 1993-May 1995 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 10,571, at 26,234 (E.D. Ark. July 7, 1994), *aff'd*, 52 F.3d 734 (8th Cir. 1995) (dismissing the plaintiff's claim that an

ers of trademarked goods who resell the goods to retail outlets.[152] A Florida franchise exists when the buyer is given "the right to offer, sell, and distribute goods" that are manufactured, processed, or distributed by the seller, and the buyer's business substantially relies on the seller for supplies.[153]

5. Exemptions and Exclusions

a. Crazy Quilt

Reliance on state exemptions to avoid state franchise law problems is difficult because these statutes are not uniform and chaining types of businesses sell in more than one state. What one state deals with via an exemption, another state addresses via an exclusion from its definition of "franchise." A seller who is exempt under one state's franchise law may not be exempt under federal law, another state's franchise law, or yet another state's business opportunity law. Further, in some states the desired exemption is only available if the seller files a notice with the state administrator and pays an annual fee. Still further, most exemptions merely exempt the franchisor from the state's registration process. The requirement that a franchise offering circular be given to the buyer is typically still applicable.

Short articles explaining franchising often do not sufficiently highlight this "crazy quilt" reality because it defeats any attempt to communicate a coherent framework for determining if an abstract seller is ensnared by "franchise law." The author is unaware of an easy chart that reliably sets out each of the several states' scopes, exemptions, and exclusions. If one existed, its accuracy would be suspect, as the states' definitions of the same words may differ,

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agreement fell within the Arkansas Franchise Practices Act because the act only applies to those agreements that require a franchise to be established at a location within the state); Hardee's of Maumelle, Ark., Inc. v. Hardee's Food Sys., Inc., [June 1992-Dec. 1993 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 10,322 (S.D. Ind. Apr. 2, 1993), *aff'd*, 31 F.3d 573 (7th Cir. 1994) (finding the defendant's actions exempt from the Arkansas Franchise Practices Act based on a provision of the act removing coverage for those business arrangements subject to the rule); Dr. Pepper Bottling Co. of Paragould v. Frantz, 842 S.W.2d 37, 39 (Ark. 1992) (concluding that the lower court did not err in denying summary judgment against Dr. Pepper when Dr. Pepper argued the state franchise law did not apply to a "franchisee" without a fixed business location).

152. *See* DEL. CODE ANN. tit. 6, § 2551(1) (1974) (defining "franchised distributor," which includes the purchase for the primary purpose of retailing).

153. FLA. STAT. ANN. § 817.416(1)(b) (West 2000).

change from time to time, are subject to different state-specific regulations, and are interpreted differently by each state's courts and local juries. As a practical matter, to reliably determine that a multi-state chaining, licensing, or distribution business is not a franchise requires looking at the real-world seller's acts and each applicable state's statutes and regulations.

b. Fractional Franchise

Although California, Illinois, Indiana, Michigan, Minnesota, New York, Virginia, and Wisconsin have a "fractional franchise" or "experienced franchisee" exemption similar to the federal exemption,[154] the exemptions in these states do not exactly mirror the federal exemption. Some states have additional conditions for applicability and most only deal with registration—not the offering circular requirement. Further, Hawaii, Maryland, North Dakota, Oregon, Rhode Island, South Dakota, and Washington do not have such an exemption. A seller's reliance on the fractional franchise exemption as the sole means of avoiding franchise law is more complicated than it would appear at first glance. These complexities illustrate the care and trouble one is put to in seeking to rely on exemptions.

c. Large/Experienced Franchisor

In nine states, a franchisor with a large net worth or significant franchise experience may be exempt from state registration, but not disclosure requirements.[155] The franchisor typically must have a net worth of $1 million and/or have conducted business of the type it is franchising for at least five years or meet other experience

154. CAL. CORP. CODE ANN. § 31109 (Deering Supp. 2004); 815 ILL. ADMIN. CODE 705/5 (West 2004); IND. CODE ANN. § 23-2-2.5-1(a) (Michie 2004); MICH. COMP. LAWS § 445.1506 (2004); MINN. STAT. ANN. § 80C.03(f) (West 2003); N.Y. COMP. CODES R. & REGS. tit. 13, § 200.10 (2004); VA. CODE ANN. § 13.1-550 (Michie 2004); WIS. STAT. ANN. § 553.235 (West 2003).

155. CAL. CORP. CODE ANN. § 311001(b) (Deering Supp. 2004); 14 ILL. ADMIN. CODE § 200.202(e) (2004); IND. CODE ANN. § 23-2-2.5-3 (Michie 2004); MD. REGS. CODE tit. 2, § 2.810.D (2004); N.Y. GEN. BUS. LAW § 684 (McKinney 2004); N.D. CENT. CODE § 51-19-04 (2004); R.I. GEN. LAWS § 19-28.1-6(4) (2004); S.D. CODIFIED LAWS § 37-5A-12 (Michie 2004); WASH. REV. CODE ANN. § 19.100.030(4) (West 2004).

criteria.[156] Most states condition the exemption on the franchisor filing a form with the state and paying a fee.

d. Sale to an Existing Franchisee

Renewals of existing franchises or sales of additional units to existing and experienced franchisees may be exempt.[157] This exemption is often limited by a requirement that there be no material change in the relationship between the franchisee and franchisor and that the franchisor file a form with the state and pay a fee.[158]

e. Franchisee's Sale of Its Franchise

The sale by a franchisee of its own franchise may be exempt.[159] However, if the franchisor takes a transfer fee or requires the new franchisee to enter into a new franchise agreement, then the franchisor is likely not exempt. In this event, the franchisor may have to comply with applicable disclosure and registration laws.

f. Other Exemptions

A few states exempt franchise sales when they are below or above a threshold sales or investment amount. California exempts

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156. *See, e.g.*, IND. CODE ANN. § 23-2-2.5-3 (Michie 2004) (requiring a net worth of not less than $1 million); MD. REGS. CODE tit. 2, § 2.8.10.D (2004) (providing for an exemption if the franchisor's net equity is at least $10 million on a consolidated basis or at least $1 million in addition to being at least eighty percent owned by an entity with a net equity of at least $10 million).

157. "Experienced" is defined as two years of experience. *See, e.g.*, CAL. CORP. CODE § 31018 (Deering Supp. 2004) (providing, however, that a material change in the franchise is a "sale"); HAW. REV. STAT. ANN. § 482E-4(6) (Michie 2004) (exempting sale of an additional franchise to an existing franchisee).

158. *See, e.g.*, HAW. REV. STAT. ANN. § 482E-4(5) (Michie 2004) (exempting renewal or extension of a franchise relationship as long as there is no material change in the relationship); R.I. GEN. LAWS § 19-28.1-6(6) (2004) (expressing the same viewpoint as the Hawaii statute).

159. *See, e.g.*, CAL. CORP. CODE § 31102 (Deering Supp. 2004) (exempting the offer or sale of a franchise by the franchisee if the franchisee is not an affiliate of the franchisor); R.I. GEN. LAWS § 19-28.1-6(2) (2004) (exempting the offer or sale of a franchise by the franchisee if the franchisee is not an affiliate of the franchisor); WIS. STAT. ANN. § 553.23 (West 2004) (exempting sub-franchisors if the sale of the franchise is not effected by or through the franchisor); *see also* Toppen v. Roy, No. 30429-5-II, 2004 Wash. App. LEXIS 1907, at *10-12 (Wash. Ct. App. Aug. 17, 2004) (affirming the lower court's judgment for the franchisee-franchise under Washington law).

sales to so-called "sophisticated franchisees."[160] Some states permit the franchise administrator to exempt sales when regulation in a particular case is not necessary to protect the public.[161] Lines of commerce that are specifically regulated, such as gasoline service stations and car dealerships, are sometimes preempted or expressly exempted.[162] Other miscellaneous exemptions exist.[163] Texas's exemptions are discussed below.

III. "BUSINESS OPPORTUNITY" DEFINED

A. *Federal Definition of Business Opportunity*

1. In General

The distinction between a franchise and a business opportunity is primarily that the former encompasses the purchaser's substantial use of the seller's trademark, and the latter encompasses the seller setting the purchaser up in a business for which the seller will supply goods or services to the buyer with accounts or locations. While there is a substantial amount of business opportunity abuse, the FTC business opportunity definition is not typically a "gotcha" problem for unintentional franchisor-type businesses due to the narrow requirement that the seller supply accounts or locations. On the other hand, the franchise definition elements of a common

160. *See* CAL. CORP. CODE § 31109 (Deering Supp. 2004) (providing exemptions for certain purchasing entities based in part on net worth).

161. *See, e.g.*, CAL. CORP. CODE § 31100 (Deering Supp. 2004) (enabling the commissioner to exempt transactions, inter alia, not necessary to protect the public interest); 815 ILL. COMP. STAT. ANN. 705/9 (West 2004) (authorizing the administrator to exempt transactions that fall under certain circumstances, including those not necessary to protect the public interest).

162. *See* Petroleum Marketing Practices Act, 15 U.S.C. §§ 2801–2806 (2003) (applying to franchise relationships between refiners, distributor, and retailers).

163. California, Rhode Island, and Washington exempt sales to a franchisor's insiders. CAL. CORP. CODE § 31106 (Deering Supp. 2004); R.I. GEN. LAWS § 19-28.1-6(3) (2004); WASH. ADMIN. CODE § 460-80-108-(4) (2004). Rhode Island and Washington exempt sales to franchisees with a net worth of more than $1 million or an annual income of $200,000. R.I. GEN. LAWS § 19-28.1-6(4)(i) (2004); WASH. ADMIN. CODE § 460-80-108(5), (6) (2004). Some states exempt sales of franchises if the franchise location will be outside the state, which may create interesting conflicts of law issues. CAL. CORP. CODE § 31105 (Deering Supp. 2004); R.I. GEN. LAWS § 19-28.1-7 (2004). Some states have "limited offer" exceptions for isolated sales. *See, e.g.*, IND. CODE ANN. § 23-2-2.5-3 (Michie 2004) (exempting franchisors that sell no more than one franchise every 2 years); N.Y. GEN. BUS. LAW § 681.5. (McKinney 2004) (providing an exemption for "isolated" sales of franchises). The terms of these exemptions vary from state to state.

trademark and significant control or assistance are not required for a transaction to be a business opportunity. While the FTC Rule treats franchises and business opportunities equally, most states regulate them under separate statutes. Shades of gray and overlap between the two are common. The 2004 FTC Staff Report recommends that the FTC business opportunity regulations be moved entirely from the FTC franchise regulations and given their own section, thus permitting business opportunities to be treated separately.[164]

A seller who helps set up an inexperienced buyer in business with a representation on an assured market—such as a manufacturer who turns over a territory, including established accounts or locations—and charges for the privilege has probably created an FTC Rule business opportunity.

2. Definition

Sections 436.2(a)(1)(ii) and 436.2(a)(2) of the FTC Rule define a business opportunity.[165] Generally, a federal business opportunity exists if three conditions are met:

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164. Bureau of Consumer Prot., Fed. Trade Comm'n, Disclosure Requirements and Prohibitions Concerning Franchising: Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR Part 436), 12 (Aug. 2004), *at* http://www.ftc.gov/os/2004/08/0408franchiserulerpt.pdf.

165. 16 C.F.R. § 436.2(a) (2003). The term *franchise* means any continuing commercial relationship created by any arrangement or arrangements whereby:

. . . .

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

(*1*) Supplied by another person (hereinafter "franchisor"); or

(*2*) Supplied by a third person (e.g., a supplier) with whom the franchisee is directly or indirectly required to do business by another person (hereinafter "franchisor"); or

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

(B) The franchisor:

(*1*) Secures for the franchisee retail outlets or accounts for said goods, commodities, or services; or

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

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

(1) Buyer Resells Seller's Goods or Services. The Buyer sells goods or services supplied by the Seller, its affiliates, or suppliers specified by the Seller;[166]
(2) Seller Provides Accounts or Locations. The Seller directly or indirectly secures for the Buyer (a) retail outlets, or (b) accounts or locations for vending devices or product sales displays to sell the goods or services or to distribute them;[167] and
(3) Required Payment of $500. There is a required payment of $500 or more to the Seller or its affiliate to obtain the opportunity.[168]

3. Example

Seller and Buyer enter into an agreement in which Buyer will purchase automobile aftermarket products (e.g., oil filters, gas additives, etc.) or operate vending machines at various locations. Seller will use his goods offices to help Buyer find either the goods or locations to sell the goods. Buyer either (1) pays at least $500 for Seller's assistance, (2) has to buy more than a reasonable inventory to begin operation, or (3) must purchase goods priced higher than the bona fide wholesale price for such goods elsewhere.[169]

The FTC Rule's exemptions and exclusions and the required payment requirement are discussed in Part IIB2. The element of helping a buyer secure outlets occurs more often than one might expect, but is not an element most businesses are likely to encounter. Further, the FTC Rule does not provide for a private cause of action, and Texas has its own BOA.[170] Therefore, discussion of the FTC Rule's business opportunity elements is deferred until this Article's later discussion of them with the BOA.

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(2) The franchisee is required as a condition of obtaining or commencing the franchise operation to make a payment or a commitment to pay to the franchisor, or to a person affiliated with the franchisor.

Id.

166. *See* 16 C.F.R. § 436.2(a)(1)(ii)(A) (2003) (explaining that resale of goods and services to persons other than the franchisor is a requirement).

167. *See* 16 C.F.R. § 436.2(a)(1)(ii)(B) (2003) (articulating the acts of the franchisor that bring the transaction within the Rule's coverage).

168. *See* 16 C.F.R. § 436(a)(3)(iii) (2003) (exempting from coverage those transactions that do not require payment of $500 or more within the first six months after beginning operations); *see also supra* Part II.B.1.c (discussing the payment requirement).

169. *See generally* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,968 (Aug. 24, 1979) (discussing the conditions applicable to 16 C.F.R. §§ 436.2(c)(1)(ii), 436.2(a)(2)).

170. TEX. BUS. & COM. CODE ch. 41 (Vernon 1994).

B. *State Definitions of Business Opportunity*

1. In General

Twenty-five states regulate business opportunity sales.[171] In California, Indiana, Maryland, Michigan, South Dakota, and Virginia, sales covered by the state's franchise statute are exempt from its business opportunity law.[172] Minnesota and Washington include a business opportunity definition as an alternative definition of "franchise" in their franchise statutes.[173]

2. Majority Definition

a. Definition

Fourteen states (Florida, Georgia, Iowa, Louisiana, Maryland, Michigan, Minnesota, North Carolina, Oklahoma, South Carolina, South Dakota, Utah, Virginia, and Washington) share substantially the same definition of "business opportunity":

> The sale or lease of any products, equipment, supplies, or services that are sold to the purchaser for the purpose of enabling the purchaser to start a business and in which the seller represents:

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171. ALASKA STAT. § 45.66.010-45.66.900 (2004); CAL. CIV. CODE §§ 1812.200-1812.221 (Deering Supp. 2004); CONN. GEN. STAT. ANN. §§ 36-503-36.529 (West 2004); FLA. STAT. ANN. §§ 559.80-559.815 (West 2004); GA. CODE ANN. §§ 10-1-410 to 10-1-417 (Harrison 2004); 815 ILL. COMP. STAT. ANN. §§ 602/5-1 to 602/99-1 (West 2004); IND. CODE ANN. §§ 24-5-8-1 to 24-5-8-21 (West 2004); IOWA CODE ANN. §§ 523B.1-523B.13 (West 2004); KY. REV. STAT. ANN. §§ 367.801-367.809 (Michie 2004); LA. REV. STAT. ANN. §§ 51:1821-1824 (West 2004); ME. REV. STAT. ANN. tit. 32, §§ 4691 to 4700-B (West 2004); MD. CODE ANN., BUS. REG. §§ 14-101 to 14-129 (2004); MICH. COMP. LAWS ANN. §§ 445.901-445.921 (West 2004); MINN. STAT. ANN. § 80C.01 (West 2003); NEB. REV. STAT. ANN. §§ 59-1701 to 59-1762 (Michie 2004); N.H. REV. STAT. ANN. §§ 358-E:1 to 358-E:6 (2004); N.C. GEN. STAT. §§ 66-94 to 66-100 (2004); OHIO REV. CODE ANN. §§ 1334.01-1334.99 (West 2004); OKLA. STAT. ANN. tit. 71, §§ 801-829 (West 2004); S.C. CODE ANN. §§ 39-57-10 to 39-57-80 (Law. Co-op. 2004); S.D. CODIFIED LAWS §§ 37-25A-1 to 37-25A-54 (Michie 2004); TEX. BUS. & COM. CODE ANN. ch. 41 (Vernon 2002); UTAH CODE ANN. §§ 13-15-1 to 13-15-7 (2004); VA. CODE ANN. §§ 59.1-262 to 59.1-269 (Michie 2004); WASH. REV. CODE ANN. §§ 19.110.010-19.110.930 (West 2004).

172. CAL. CIVIL CODE § 1812.201(b)(2) (Deering 2004); IND. CODE ANN. § 24-5-8-1 (West 2004); MD. CODE ANN., BUS. REG. § 14-104 (West 2003); MICH. COMP. LAWS ANN. § 445.902 (2004); S.D. CODIFIED LAWS § 37-25A-2(3) (Michie 2004); VA. CODE ANN. § 59.1-263 (Michie 2004).

173. MINN. STAT. ANN. § 80C.01 Subd. 4(3) (West 2003); WASH. REV. CODE ANN. § 19.100.010(4) (West 2004).

(1) that the seller will provide locations or assist the purchaser in finding locations for the use of vending machines, racks, display cases or other similar devices; or
(2) that the seller will purchase any or all products made, produced, fabricated, grown, bred, or modified by the purchaser using in whole or in part the supplies, services, or chattels sold to the purchaser; or
(3) that the seller guarantees the purchaser will derive income from the business opportunity that exceeds the price paid for that opportunity, or that the seller will refund all or part of the price paid for the business opportunity, or repurchase any of the products, equipment, supplies, or chattels supplied by the seller, if the purchaser is dissatisfied with the business opportunity; or
(4) that upon payment by the purchaser of a fee, the seller will provide a sales program or marketing program to the purchaser.[174]

b. "To Start a Business"

The seller must enable the purchaser to start a business. Whether a sale to an existing business differs sufficiently from the existing business to be considered "starting a new business" is judged according to factors such as those discussed under the federal fractional franchise exemption.[175] Neither sales to established businesses nor the sale of an ongoing business is covered by business opportunity statutes.[176]

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174. The definition is for discussion purposes only. The specific statute of each state must be reviewed. FLA. STAT. ANN. § 559.801 (West 2004); GA. CODE ANN. § 10-1-410 (Harrison 2004); IOWA CODE ANN. § 523B.1 (West 2004); LA. REV. STAT. ANN. § 51:1821 (West 2004); MD. CODE ANN., BUS. REG. § 14-101 (2004); MICH. COMP. LAWS ANN. § 445.902 (West 2004); MINN. STAT. ANN. § 80C.01 Subd. 4(3) (West 2003); N.C. GEN. STAT. § 66094 (2004); OKLA. STAT. ANN. tit. 71, § 802 (West 2004); S.C. CODE ANN. §§ 39-57-20 to 39-57-80 (Law. Co-op. 2004); S.D. CODIFIED LAWS § 37-25A-1 (Michie 2004); UTAH CODE ANN. § 13-15-2 (2004); VA. CODE ANN. § 59.1-263 (Michie 2004); WASH. REV. CODE ANN. § 19.100.020 (West 2004). The threshold fee varies from fifty dollars in Florida to $500 in Iowa, Michigan, and Utah.

175. *See supra* Part.II.B.2.a (discussing the fractional franchise exemption).

176. *See, e.g.*, Eye Assocs., P.C. v. IncomRx Sys. Ltd. P'ship, 912 F.2d 23, 27 (2d Cir. 1990) (remanding the case for determining material facts about whether the marketing agreement enabled the start of a new business and therefore violated the Connecticut Business Opportunity Investment Act); Bunting v. Perdue, Inc., 611 F. Supp. 682, 688 (E.D.N.C. 1985) (agreeing that the North Carolina Business Opportunity Sales Act specifically applies to a starting business rather than an on-going business); Batlemento v. Dove Fountain, Inc., 593 So. 2d 234, 239 (Fla. Dist. Ct. App. 1991) (holding that the Florida Business Opportunities Act specifically excludes ongoing businesses).

c. Threshold Representations

If a sale meets any of the following subsections, the sale satisfies the "threshold representation" element.

(1) *Vending Machines and Chinchilla Farms.* Subsections (1) and (2) are generally directed to vending machines, chinchilla farms, and similar activities. More actual disputes collect in these two subsections than would logically seem possible.[177]

(2) *Guarantee of Repurchase.* This section is rarely met on the face of the signed agreement. In the real world, however, salesmen are genetically different from non-salesmen. The particular seller's salesman is on a straight commission and his six-month old child is hungry. While the contract does not say such, a salesman may "guarantee," "promise," or "represent" to a prospective buyer that the buyer will make money or can return unsold or unneeded goods, or that part of the purchase price will be refunded if the buyer changes his mind.

(3) *Marketing Program.* The expanse implied by the subsection (4) phrase "a sales program or marketing program" can be inferred from the prior discussion with respect to franchise statutes and is more directly addressed below concerning the Texas BOA.[178]

(4) *Required Payment.* The required "fee" is minimal—from $50 to $500. Importantly, there is not an exception akin to the FTC Rule bona fide wholesale price exception. Overpriced or required supplies, equipment, or marketing aids may be counted toward the required payment.

d. The Trademark Difference

Business opportunity statutes do not require the license of or association with a trademark. Thus, providing a sales or marketing program without an associated trademark can be a business opportunity and not a franchise. On the other hand, because pure trademark licensing agreements typically do not involve the "sale or lease of any products, equipment, supplies, or services," they are

177. *See* Fishermen's Net, Inc. v. Weiner, 608 F. Supp. 1283, 1285 (D. Me. 1985) (deferring the question of whether a shopping center lease that included common area seating, decorations, and promotional services falls within the Maine Business Opportunity Act to Maine's highest court).

178. *See supra* Part II.C.2 (discussing the definition of "marketing plan"); *see also infra* Part III.C.5.c (discussing marketing programs under Texas law).

typically not business opportunity agreements.[179] Inclusion of a trademark in the relationship does not prevent the relationship from being both a franchise and a business opportunity, but some states exempt "franchises" from their business opportunity statute.

e. Exemptions

Connecticut, Georgia, South Carolina, Louisiana, Maine, North Carolina, and Utah statutes exempt from the "sales program or marketing program" element an opt-out for "a marketing program made in conjunction with the licensing of a registered trademark or service mark." This is a relic from decades past when obtaining a federal trademark registration often took a couple of years. Lobbyists for established business realized that a federal trademark-based exemption would benefit their clients. The argument behind the exemption was that long-lived interstate businesses were unlikely to be bad actors. Over time, state trademark registrations were added to this exclusion, thus gutting the statute because many state trademark registrations can be obtained in days.

Otherwise, the exemptions and exclusions discussed above are applicable. Business opportunity statutes do not require the license of or association with a trademark. Thus, providing a sales or marketing program without an associated trademark can be a business opportunity and not a franchise. On the other hand, pure trademark licensing agreements that do not involve the "sale or lease of any products, equipment, supplies, or services" are not business opportunity agreements.[180]

3. Other States

California, Nebraska, Indiana, Ohio, New Hampshire, and Kentucky have business opportunity definitions that differ substantially from the majority definitions.[181] The above discussion, however, provides general guidance.

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179. *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,968 (Aug. 24, 1979) (defining "business opportunity ventures" under the FTC rule).

180. *See id.* (defining "business opportunity ventures" under the FTC rule).

181. *See supra* note 174 (providing the state fee requirements).

C. *Texas Definition of Business Opportunity*

1. Definition

Texas has a unique definition of "business opportunity," defining the term to mean:

> [A] sale or lease for an initial consideration of more than $500 of products, equipment, supplies, or services that will be used by or for the purchaser to begin a business in which the seller represents that:
> (1) the purchaser will earn or is likely to earn a profit in excess of the initial consideration paid by the purchaser; and
> (2) the seller will:
> (A) provide locations or assist the purchaser in finding locations for the use or operation of the products, equipment, supplies, or services on premises that are not owned or leased by the purchaser or seller;
> (B) provide a sales, production, or marketing program; or
> (C) buy back or is likely to buy back products, supplies, or equipment purchased or a product made, produced, fabricated, grown, or bred by the purchaser using in whole or in part the product, supplies, equipment, or services that the seller initially sold or leased or offered for sale or lease to the purchaser.[182]

Texas has no reported decisions construing the BOA. Thus, understanding and applying the BOA definition requires a familiarity with how the same or similar terms are used in the FTC Rule and other states' laws discussed above.[183]

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182. TEX. BUS. & COM. CODE ANN. § 41.004(a) (Vernon 1994) (defining "business opportunity," which also requires that the seller represent that the buyer will likely earn a profit in excess of his initial consideration).

183. For an excellent annual update of Texas franchise law developments, consult the SMU Law Review's annual survey of Texas franchise law by Deborah S. Coldwell. *See generally* Deborah S. Coldwell et al., *Franchise Law, Annual Survey of Texas Law*, 57 SMU L. REV. 1035 (2004). *See generally* Jane Fergason, *The Texas Business Opportunity Act: A Critical Analysis*, 34 BAYLOR L. REV. 348 (1982) (proposing that the ambiguities within the Texas Business Opportunity Act create a potentially ineffective statute); Joyce Mazero & John Holzgraefe, *A Practical Guide to the 1985 Amendments of the Texas Business Opportunity Act*, 4 FRANCHISE LEGAL DIG. 3 (1985); Mark H. Miller, *Franchising in Texas*, 14 ST. MARY'S L.J. 301 (1983) (providing a general overview of franchising law in Texas); Homer G. Price et al., *Franchising in Texas*, FRANCHISE L.J., Fall 1986, at 1 (warning that the FTC rule may prove significant in franchise litigation because violations of the BOA may also violate the DTPA).

2. Three-Part Test

The BOA in practice has a three-part business opportunity definition:

(1) *"To begin a business."* The items or services purchased or leased by the purchaser must be used by or on his behalf to begin a business;[184]

(2) *$500.* The purchaser is obligated to pay initial consideration exceeding $500 to begin the business;[185] and,

(3) *Threshold Representation.* The seller must make any one of the three listed threshold representations.[186]

This definition covers a broader range of business arrangements than the previously discussed franchise or business opportunity statutes.

The Section 41.004(a)(1) requirement that "the seller represents that . . . the purchaser will earn or is likely to earn a profit in excess of the initial consideration paid by the purchaser"[187] is met in most circumstances. Buyers of business opportunities buy because they believe they are going to make a profit; that belief was developed from some source of information. Typically, the business opportunity seller has the ability, opportunity, and motive to provide information to the buyer relevant to the buyer's calculations in this regard.

The questioning of the buyer and seller in front of the jury on this point is easy to envisage. The buyer will testify that the seller's salesman said the business opportunity was a "good deal" and had a good chance of succeeding. The seller's salesman will then be questioned. If the salesman denies ever making such a representation, the evidentiary door is opened to rebuttal by all prior buyers the salesman sold to. As the jury's most basic role is to determine and punish liars, unsuccessfully contesting this point may color the entire case.

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184. TEX. BUS. & COM. CODE ANN. § 41.004(a) (Vernon 1994).

185. *Id.*

186. *See* TEX. BUS. & COM. CODE ANN. § 41.004(a)(2)(A)-(C) (Vernon 1994) (indicating that a business opportunity exists when, *inter alia*, the seller will provide locations to the buyer, provide a marketing program to the buyer, or will buy back products or equipment that the seller initially sold or offered for sale to the purchaser).

187. TEX. BUS. & COM. CODE ANN. § 41.004(a)(1) (Vernon 1994).

3. "To Begin a Business"

This requirement will normally be unquestionably met or not met. A purchaser of franchise rights to a new market area who lacks experience in the subject line of commerce is "beginning a business." A purchaser of an enterprise that has operated at the same location for a long time is not "beginning a business," but purchasing an ongoing business. This is further clarified in the "ongoing business" exemption of Section 41.004(b)(1).[188]

Sometimes a buyer will expand his current business by taking on a new line. As discussed below, rules for construction include reference to interpretations of similar terms in the FTC Rule.[189] A gasoline station operator with over two years of experience who purchases a retail oil additive dealership anticipated to be less than twenty percent of the dollar volume of his projected gross sales for use at his service station is *not* beginning a business.[190] A dry cleaning opportunity offered to the same gasoline station owner likely *would* be a new business, even if operated from the same location, subject to the Section 41.004(b)(8) fractional franchise exemption.[191] There will certainly be close fact situations calling for submission of a jury question.[192]

4. "Initial Consideration"

The BOA defines "initial consideration" as "the total amount a purchaser is obligated to pay under a business opportunity contract before or at the time the equipment, supplies, products, or services are delivered or within six months after the date the purchaser begins operation of the business opportunity plan."[193] If the contract indicates a specific total sale price for purchase of the business opportunity plan that is to be paid partially as down payment and the

188. *See* discussion *infra* Part III.C.6.b (analyzing the ongoing business exemption under Texas law).

189. TEX. BUS. & COM. CODE ANN. § 41.002 (Vernon 1994).

190. *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,986 (Aug. 24, 1979) (providing the conditions for exempting fractional franchises from the rule).

191. *See* TEX. BUS. & COM. CODE ANN. § 41.002 (Vernon 1994) (referencing 16 C.F.R. § 436.2).

192. *See* Eye Assocs., P.C., v. IncomRx Sys. Ltd. P'ship, 912 F.2d 23, 27 (2d Cir. 1990) (reiterating that mere alterations of an existing business may be sufficient to "begin a business").

193. TEX. BUS. & COM. CODE ANN. § 41.003(5) (Vernon 1994).

remainder with additional payments of installments, "initial consideration" means the entire sale price.[194] The term, however, does not include the not-for-profit sale of samples, equipment, and sales demonstration materials not to exceed $500.[195]

In contrast to the FTC Rule, this definition does not contain a bona fide wholesale goods exemption.[196] Thus, any contractual requirement to pay a cumulative $500 for goods or services to be used by the buyer to begin the business prior to or at delivery during the first six months after commencing operations satisfies this part, even if the seller is merely selling the buyer inventory for resale and even if the goods are priced below the seller's cost. On the other hand, if the buyer is *not* obligated to pay for the goods or services until more than six months after commencing operations, then those payments are *not* "initial consideration."

This distinction is due to one of the abuses the state was intending to prevent: buyers paying up front and then sellers not delivering. If the goods and services are delivered, and the buyer has a fair chance to evaluate them before paying, then normal business law is sufficient to protect the buyer. That the six month period begins upon "the purchaser [beginning] operation of the business opportunity plan"—an unknowable date—makes it difficult to draft standard documents to avoid this period. Further, because start-up businesses are an awful credit risk, few sellers will defer payment for six months. Alternatively, payments required by the contract may be made for the intangible business opportunity right itself as opposed to the "goods and services" identified in the first sentence of Section 41.003(5).[197] These payments are not limited to the first six months for accumulation of the requisite $500 if made "for purchase of the business opportunity"; they are summed to reach the threshold $500 regardless of when they are required to be paid. For example, a requirement that the buyer make five an-

194. *Id.*

195. *Id.* § 41.003(5).

196. *Compare id.* (declining to include wholesale goods in the definition of "initial consideration"), *with* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. at 49,967 (Aug. 24, 1979) (describing the FTC's intent to capture all hidden franchise fees).

197. *See* Meineke Disc. Muffler Shops, Inc. v. Jaynes, 999 F.2d 120, 125 (5th Cir. 1993) (denying DTPA consumer status to the respondents because their complaint against Meineke concerned an intangible property right rather than goods or services).

nual $100 payments meets this condition. The Section 41.003(5) trigger is not payment of the $500, but merely the obligation to pay it.[198]

The jurisdictional "initial consideration" must be intended "to begin a business" within the meaning of Section 41.004(a).[199] BOA defendants will argue that payments for supplies and other products or services delivered within the six-month period but after the purchaser commenced operations may look like the initial consideration defined in Section 41.003(5), but are not being used to begin a business as required by Section 41.004(a). BOA defendants will further argue that the "obligated to pay under a business opportunity contract" language means that only amounts specified in the purchase agreement may be summed to reach the required $500. They will also argue that monies required to be paid pursuant to other agreements between the seller and the purchaser for goods or services, or purchases of goods or services that are not set out in any agreement, do not count toward the $500 threshold.

The legislature's expressed intent, however, that the BOA protect "against false, misleading, or deceptive practices in the . . . sale . . . of business opportunities"[200] and direction that interpretations of the FTC Rule be followed "to the extent possible"[201] will be considered by Texas courts in close cases.

The FTC's Final Guides state:

> [R]equired payments are not limited to a simple franchise fee, but entail other payments which the franchisee is required to pay to the franchisor or an affiliate, either by contract or by practical necessity. Among the forms of required payments are initial franchise fees as well as those for rent, advertising assistance, required equipment and supplies—including those from third parties where the franchisor or its affiliate receives payment as a result of such purchases—training, security deposits, escrow deposits, non-refundable bookkeeping charges, promotional literature, payments for services of persons to be established in business, equipment rental, and continuing royalties on sales.

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198. *See* TEX. BUS. & COM. CODE ANN. § 41.003(5) (Vernon 1994) (indicating the amount in question is "the total amount a purchaser is obligated to pay").

199. *Id.* § 41.004(a).

200. *Id.* § 41.002(a)(1).

201. *Id.* § 41.002(b).

> The payments may be required either by contract or by practical necessity. Payments required by contract would include not only those required by the franchise agreement, but also those required in any companion contracts which the parties may execute, such as a real estate lease. Payments made by practical necessity include, among others, those for equipment which can only be obtained, in fact, from the franchisor or its affiliate.[202]

These guidelines will be considered by a Texas court facing these above defensive arguments. Perhaps the court will make a variation of the Final Guides a jury instruction, or perhaps the court will hold that the BOA's text is sufficiently specific that guidance is unnecessary. Absolute reliance on any of the above arguments is precarious.

5. Threshold Representations

a. In General

There are three BOA-invoking threshold representations: (1) that the seller will help find a location; (2) that the seller will provide a marketing program; or (3) that the seller will provide an opportunity to repurchase.[203] These threshold representations, like the Deceptive Trade Practices-Consumer Protection Act's (DTPA) laundry list representations, only have to be made to meet the statutory threshold requirement.[204] In contrast to a common-law action for fraud, the purchaser does not have to rely on or even believe the seller's representation.[205] If the seller utters the magic words and all other requirements are met, he acquires BOA "seller" status. The jury question is merely, "Did the seller represent . . . ?" Likely most such questions will concern implied representations. An additional fertile ground for dispute and jury questions is likely to be agency issues concerning the seller's sales-

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202. Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,967 (Aug. 24, 1979).

203. TEX. BUS. & COM. CODE ANN. § 41.004(a)(1)(A)-(C) (Vernon 1994).

204. *Compare* TEX. BUS. & COM. CODE ANN. § 17.46 (Vernon 1994) (enumerating the "laundry list" of DTPA violations), *with* TEX. BUS. & COM. CODE ANN. § 41.004 (Vernon 1994) (outlining the three possible threshold representations by a seller that would give rise to a claim under the BOA).

205. *See* BLACK'S LAW DICTIONARY 594 (5th ed. 1979) (defining "fraud" as "[a] false representation of a matter of fact . . . which deceives and is intended to deceive another so that he shall act upon it to his legal injury").

person who made the representations. The seller will likely prove, with uncontroverted evidence, that the salesperson had no express authority to make such representations. Often the sales agreement itself disclaims these representations. Such disclaimers, while perhaps effective to defeat the proximate cause element, may or may not undo the threshold representation effect of a salesman uttering a Section 41.004(a)(2) incantation. The salesman's apparent authority will be a contested issue.

b. Help Finding a Location

This representation is similar to the location representation common in other states' business opportunity laws. While primarily directed toward vending machines, chinchilla farms, and similar activities, it applies to more fact situations than logic would appear to allow.[206] Examples of circumstances that meet this requirement are where

> the franchisor may represent that he will secure ten gasoline stations to be retail outlets for automotive after-market products (*e.g.,* oil filters, gas additives, etc.) or place vending machines in ten locations. The franchisee of a business opportunity venture is required to pay a fee or purchase goods or equipment (such as vending machines or display racks) in order to participate in the business opportunity offered by the franchisor.[207]

c. Providing a Marketing Program

The requisite representation that the seller will "provide a sales, production, or marketing program"[208] is much broader than it appears at first glance. "Marketing program" is extensively defined as:

> [A]dvice or training that is given to the purchaser by the seller or a person recommended by the seller pertaining to the sale of products, equipment, supplies, or services and that includes the preparation or provision of:

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206. *See* Mirza v. TV Temp, Inc., Cause No. 84-CI-07495 (288th Dist. Ct., Bexar County, Tex. Dec. 28, 1987) (awarding $1.45 million to plaintiffs based in part on the defendant's failure to provide the required disclosure statements at least ten days before the plaintiffs signed a master distributorship agreement).

207. Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,968 (Aug. 24, 1979).

208. TEX. BUS. & COM. CODE ANN. § 41.004(a)(2)(B) (Vernon 1994).

(A) promotional literature, brochures, pamphlets, or advertising materials;
(B) training regarding the promotion, operation, or management of the business opportunity; or
(C) operational, managerial, technical, or financial guidelines or assistance.[209]

Many, if not most, sellers help their buyers use or resell the items. Sellers want to make customers happy, repeat customers. Particularly where the seller is providing goods and services to a buyer who is beginning a business, additionally providing advice, training, and sales aids are low-cost ways to make buyers more likely to succeed and add value to the transaction. That such well-intentioned efforts may meet this BOA threshold representation element is shown in the previous discussion concerning the FTC Rule's Section 436.2(1)(i)(B)(2) "significant assistance" element and other states' marketing plan element.[210]

d. Repurchasing

The "buy back or is likely to buy back" representation is triggered if the seller represents that it "is likely" to buy back products made by the buyer using products, supplies, equipment, or services sold to the buyer by the seller.[211] This is a lower threshold than other business opportunity statutes, which sometimes require a seller's guaranteed buy-back as a threshold requirement. Further, "buy-back" includes any representation which implies in any manner that the purchaser's investment is protected from loss. As discussed above, this requirement is met more often than is appreciated. Salesmen are paid on a commission to sell. Particularly where the sale involves the delivery of any reusable articles, the salesman may "imply" in some manner that the seller will "likely" repurchase unused items. If rights are sold, salesmen may imply that the seller will help the purchaser resell the rights or otherwise help the buyer out if the buyer becomes dissatisfied. Once these representations are uttered, a jury issue may exist.

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209. *Id.* § 41.003(g).

210. *See* Practice Mgmt. Assoc., Inc. v. Cochran, 564 So. 2d 642, 643 (Fla. Dist. Ct. App. 1990) (holding that an efficiency management program does not constitute a marketing plan).

211. TEX. BUS. & COM. CODE ANN. § 41.004(a)(2)(C) (Vernon 1994).

The BOA defendant's argument is typically that the major part of the business sold by him to the purchaser was clearly not returnable, and that the transaction should not be deemed a business opportunity simply because the salesman implied, without actual or apparent authority and in contradiction of the written agreement's terms, a possible buy-back of a minor portion of what was sold. Additionally, DTPA and Texas Business and Commerce Code cases characterizing some transactions as primarily dealing with intangibles or services respectively, and thus not within those statues, may be persuasive on this point.[212]

6. Exemptions

a. The Franchisor Exemption

Most franchisors rely on Section 41.004(b)(8) to exempt their franchise sales from the BOA. This section exempts arrangements defined as franchises in Section 436.2(a) if "the franchisor complies in all material respects in [Texas] with 16 C.F.R. Part 436 and each order or other action of the Federal Trade Commission; and . . . [the seller] files with the secretary of state a notice containing [certain information]."[213]

As a practical matter, this much-amended section is intended to exempt large national franchisors who deliver UFOCs as a standard practice after filing a notice with and paying a small fee to the Secretary of State.[214] The section does that, but the outer parameters and complications of trying to apply Section 41.004(b)(8) to all possible fact patterns are problematic.

The referenced Section 436.2(a) definition of "franchise" includes both Section 436.2(a)(i) relationships referred to as "package and product franchises" and Section 436.2(a)(ii) relationships referred to as "business opportunities."[215] But it may not be clear on a first reading whether sales of franchises or business opportuni-

212. *See infra* Part V.A (discussing DTPA cases concerning intangibles). Many Business and Commerce Code cases concern whether a transaction is or is not primarily a transaction concerning goods, and thus whether the transaction is covered by the Texas Business and Commerce Code.

213. TEX. BUS. & COM. CODE ANN. § 41.004(b)(8) (Vernon 1994).

214. *See* 1 TEX. ADMIN. CODE § 97.21(d) (West 2004) (stating that the filing fee is $25).

215. *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,968 (Aug. 24, 1979) (categorizing the two types of

ties that are exempt or excluded from Section 436 compliance are also exempted from the BOA via Section 41.004(b)(8). For example, fractional franchises, which are exempted from the FTC Rule, "comply" with the FTC Rule for the purposes of Section 41.004(b)(8), even if the seller does not provide a franchise disclosure document to prospective purchasers. One might creatively argue that such sellers are not exempted from Section 41.004(b)(8) because they are exempted from Section 436.2(a)—i.e., they are exempted from the exemption. The intent of Section 41.004(b)(8), however, is that if a sale is within the Section 436.2(a) definition and then exempted or excluded from the FTC Rule requirements via Section 436.3(a)(3) or (4), it is within the scope of Section 41.004(b)(8) and has satisfied that section's "complied in all material respects" requirement even without the seller providing an offering circular. This is because the FTC Rule does not require an offering circular from such seller. If the FTC adopts the 2004 Staff Report's recommendation that regulations for federal business opportunities be moved from 16 C.F.R. § 436, the text of this BOA exemption should be reexamined.

The FTC Rule's exemption of a transaction when the total of the purchaser's payments for other than reasonable quantities of wholesale goods purchased for resale within six months after commencing operations is less than $500, for example, makes a Section 436.2(a) transaction one that complies with the FTC Rule, even if an offering circular was not delivered.[216]

A practical limit to the applicability of the Section 41.004(b)(8) exemption of Section 436.2(a) franchisors or business opportunity sellers who are exempt or excluded by Section 436.3 or 436.4 is that such sellers must file an exemption statement with the Texas Secretary of State[217] and pay a fee[218] as a condition of obtaining the Texas exemption. Thus, the seller must acknowledge that he is selling a Section 436.2(a) franchise or business opportunity to claim a Texas exemption. Few sellers who do not provide a UFOC are

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transactions covered by the rule as "Package and Product Franchises" and "Business Opportunity Ventures").

216. This Article's full discussion of bona fide wholesale prices and the franchise definitional elements should be referred to in this respect. The FTC Rule's other seven exemptions and exclusions are also applicable in this regard.

217. TEX. BUS. & COM. CODE ANN. § 41.004(b)(8) (Vernon 1994).

218. 1 TEX. ADMIN. CODE § 97.21(d) (West 2004).

willing to do this, in part because the admission would conflict with the seller's bobbing and weaving to avoid other states' franchise and business opportunity statutes.

The seller's compliance "in all material respects in this state with 16 C.F.R. Part 436" is required to maintain the exemption provided by Section 41.004(b)(8).[219] This particularly encompasses the FTC Rule's five-day,[220] ten-day,[221] and first personal meeting[222] requirements for making the FTC Rule's required disclosures to a prospective franchisee. It is also necessary to provide notice of "material facts"[223] and "material changes"[224] to the prospective purchaser as required by the FTC Rule. Thus, a properly prepared offering circular will not exempt the seller from the BOA if the FTC Rule's delivery time, updating, and other requirements and prohibitions are not met.[225]

Because most franchisors use UFOC format disclosure documents, a question often arises concerning whether disclosures made in a UFOC format rather than the FTC format prescribed in the FTC Rule satisfy Section 41.004(b)(8)'s requirement of complying "in all material respects in this state with 16 C.F.R. Part

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219. TEX. BUS. & COM. CODE ANN. § 41.004(b)(8) (Vernon 1994).

220. *See* FTC Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. § 436.1(g) (2003) (dictating that it is a violation of the FTC Act if the seller fails to provide the necessary disclosures no earlier than five days before any agreement between the parties is to be executed).

221. *See* 16 C.F.R. § 436.2(g) (2003) (defining "time for making of disclosures" to mean ten business days before the earlier of the execution of a franchise agreement or the payment of consideration by a prospective franchisee).

222. *See id.* § 436.2(o) (defining "personal meeting" to mean "a face-to-face meeting between a franchisor or franchise broker . . . and a prospective franchisee which is held for the purpose of discussing the sale or possible sale of a franchise").

223. *See id.* § 436.2(n) (defining "material fact" to mean "any fact, circumstance, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchise business or which has any significant financial impact on a franchisee or prospective franchisee").

224. *See id.* § 436.1(a)(22) (requiring that a franchisor "within a reasonable time after the close of each quarter of the fiscal year, prepare revisions to be attached to the disclosure statement to reflect any material change in the franchisor or relating to the franchise business of the franchisor").

225. *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,971 (Aug. 24, 1979) (enumerating the acts and practices that violate the Rule).

436." The FTC has approved the use of the UFOC, so its use is approved under Section 41.004(b)(8).[226]

b. Ongoing Business

Section 41.004(b)(1) exempts

> the sale or lease of an established and ongoing business or enterprise that has actively conducted business before the sale or lease, whether composed of one or more than one component business or enterprise, if the sale or lease represents an isolated transaction or series of transactions involving a bona fide change of ownership or control of the business or enterprise or liquidation of the business or enterprise . . . .[227]

The typical sale of one or more on-going businesses by its owner is exempted by this section. The exemption is, however, full of litigable terms. In theory, a seller could open a business on day one, sell it on day two, and claim this exemption. As a practical matter, however, the cost and risk of getting a new business started is exactly what business opportunity and franchise sellers want to avoid. Serial "start-em-and-flip-em" entrepreneurs are rare. Successive sales would run outside of the "isolated sale" limitation in any event. There is no bright line for the number of days the business must operate to be "established and ongoing."

In contrast, for example, California defines "on-going business" as one that "for at least six months previous to the sale [1] has been operated from a particular specific location, [2] has been open for business to the general public, and [3] has had all equipment and supplies necessary for operating the business located at that location."[228] While Section 41.004(b)(1) does not require six months, this highlights the possible jury questions when the exemption is claimed by a serial seller of day-old businesses.

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226. TEX. BUS. & COM. CODE ANN. § 41.004(b)(8) (Vernon 1994). Although one case stated, as an alternative ground for dismissal of a BOA claim, that "[t]he Business Opportunity Act does not apply to the sale of a franchise as defined by 16 C.F.R. § 436.2," *Meineke Disc. Muffler Shops, Inc. v. Jaynes*, [Aug. 1990-May 1992 Transfer Binder] Bus. Franchise Guide ¶ 9959, at 22,904 (S.D. Tex. Oct. 1, 1991), *aff'd*, 999 F.2d 120 (5th Cir. 1993), there are so many exceptions to this statement that they practically engulf the rule.

227. TEX. BUS. & COM. CODE ANN. § 41.004(b)(1) (Vernon 1994).

228. CAL. CIV. CODE § 1812.201(b)(7) (Deering Supp. 2004).

c. Leased Department

Section 41.004(b)(2) exempts deals with independent retailers who sell their own goods or services from premises leased from a larger retailer in the larger retailer's store.[229] Department stores, for example, often lease some of their space to specialty shoe stores. The FTC Rule's Section 436.2(a)(3)(ii) definitions, guidelines, and opinions discussed above are persuasive concerning this exemption.[230]

d. Fractional Franchise

Section 41.004(b)(5) exempts "a sale or lease to a business enterprise that also sells or leases equipment, products, and supplies or performs services: (A) that are not supplied by the seller; and (B) that the purchaser does not use with the equipment, products, supplies, or services of the seller."[231] This exemption is identical to the "like business opportunity" exemption of other states[232] and is similar in intent to the FTC Rule's Section 436(a)(3)(i) fractional franchise definition discussed previously.[233]

The longevity of the business sold is not defined.[234] The FTC Rule's Section 436.2(5)(h) fractional franchise definition requires "two years of experience."[235] The practical limitations on a serial entrepreneur attempting to fit successive sales of start-up businesses through this exemption are formidable. Further, a seller who helps a buyer incorporate on day one for free and then relies on this exemption to cover a substantial sale of required goods and

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229. *See* TEX. BUS. & COM. CODE ANN. § 41.004(b)(2) (Vernon 1994) (exempting from coverage an agreement or contract "in which a retailer of goods or services sells the inventory of one or more ongoing leased departments to a purchaser who is granted the right to sell the goods or services within or adjoining the retail business establishment as a department or division of the retail business establishment").

230. *See supra* Part II.C.5.g (discussing other available exemptions).

231. TEX. BUS. & COM. CODE ANN. § 41.004(b)(5) (Vernon 1994).

232. *See, e.g.*, CAL. CIV. CODE § 1812.201(b)(6) (Deering Supp. 2004) (discussing what will not be included in the definition of a "seller assisted marketing plan"); NEB. REV. STAT. 59-1718 (1998) (stating that a sale or lease to an ongoing business shall not be included in the definition of a "seller-assisted marketing plan").

233. *See supra* Part II.A.1 (discussing the federal definition of franchising).

234. Prior to amendment, Section 41.004(b)(5) included sales to "an existing or beginning business enterprise." *See* TEX. REV. CIV. STAT. ANN. art. 5069, § 16.06(E) (Vernon 1987) (codifying the law prior to 1997).

235. *See* 16 C.F.R. § 436.2(h) (2003) (requiring the franchisee to have been in business at least two years before being exempted from the Rule's coverage under this definition).

services on day two is likely to be disappointed. The "substance over form" rule is likely to collapse everything into a single combined transaction for BOA analysis purposes.

This exemption is intended to cover transactions that add a product or service to a preexisting larger enterprise, such as a supply agreement between a tire manufacturer and a service station dealer, or even a start-up gas station. It is not intended, for example, to exempt the sale of a franchised restaurant to a person whose current "existing business" is a shoe-shine stand.

The second part of Section 41.004(b)(5) might be argued by sellers to be met if the buyer sells Girl Scout cookies in addition to the 99.99% of the seller's goods that the buyer resells. A sale of a new line of goods that is expected to comprise over 50% of the purchaser's dollar volume would clearly seem to be more than an addition to the purchaser's existing line and intended by the BOA's Preamble and direction to be beyond the exemption's reach. The FTC Rule's 20% limitation on how much of the purchaser's new dollar volume the seller can supply and still retain the FTC Rule's exemption offers guidance.[236] In the absence of state interpretations, however, the applicability of this exemption may be determined by each jury. Likely, the jury will be given a "Do you find . . . ?" jury question quoting the section and the burden of proof will be on the seller. For the jury to know what this exemption is intended to cover, the court will need to provide an instruction, which will surely go up on appeal.

e. Net Worth Exemption

Section 41.004(b)(7) of the Texas BOA exempts a seller with a net worth of $25 million according to its audited balance sheet as of a date within thirteen months of the date of the transaction.[237] This section also exempts sellers who have a parent company that meets this financial criteria and guarantees the seller's performance.[238] Measurement of net worth and the requirement of an audited bal-

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236. FTC Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. § 436.2(5)(h) (2003).

237. TEX. BUS. & COM. CODE ANN. § 41.004(b)(7) (Vernon 1994).

238. *Id.*

ance sheet are used as screens.[239] The rationale behind the exemption is that these businesses do not typically engage in the schemes against which the BOA is directed and, if they do, they are typically available to satisfy a judgment in the normal course.

f. Gasoline Stations

The Federal Petroleum Marketing Practices Act[240] preempts similar state regulation.[241] To resolve potential ambiguity, the BOA specifically exempts offers and sales of franchises covered by the Act.[242]

g. Miscellaneous Exemptions

Real estate syndications and transactions regulated by the Texas Departments of Transportation and Labor, Standards, State Board of Insurance, or the Texas Real Estate Commission, when engaged in by persons licensed by these agencies, are exempt.[243]

7. Construction

Many of the ambiguities surrounding the statute are ameliorated by the statute's direction that when construing the BOA, "a court to the extent possible shall follow the interpretations given by the [FTC] and the federal courts to Section 5(a)(1), Federal Trade Commission Act (15 U.S.C. Section 45(a)(1)), and 16 C.F.R. 436."[244] This directs the court to a large body of decided cases and

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239. *See id.* (excluding from the definition of "business opportunity" sales where the seller has a net worth of at least $25 million according to the seller's audited balance sheet).

240. Petroleum Marketing Practices Act, 15 U.S.C. § 2801-2806 (2003).

241. *See* Mehdi-Kashi v. Exxon Mobil Corp., No. Civ. A. H-01-719, 2002 WL 32052603, at *4-7 (S.D. Tex. Jan. 7, 2002) (discussing the federal courts of appeals' treatment of PMPA preemption of state laws and concluding the plaintiff's DTPA claim was preempted by the PMPA); Mercer v. Texaco, Inc., No. Civ. A. 3:98-CV-1011-R, 1999 WL 451224, at *3-5 (N.D. Tex. June 28, 1999) (granting Texaco's motion for summary judgment based on the PMPA's preemption of state law); *cf.* Subaru of Am., Inc. v. David McDavid Nissan, Inc., 84 S.W.3d 212, 228 (Tex. 2002) (requiring the plaintiff to exhaust administrative remedies before maintaining a DTPA action where the Texas Motor Vehicle Board maintained jurisdiction to regulate the distribution, sale, or lease of motor vehicles). Cases are mixed in other states concerning the extent to which the PMPA preempts state regulations and statutes.

242. TEX. BUS. & COM. CODE ANN. § 41.004(b)(6) (Vernon 1994).

243. TEX. BUS. & COM. CODE ANN. § 41.004(b)(3)-(4) (Vernon 1994).

244. *Id.* § 41.002(b).

FTC orders, guidelines, and Informal Staff Opinions.[245] Because there is not a private cause of action under the FTC Rule, the vast preponderance of cases on point are not FTC or federal court interpretations of the FTC Rule, but are rather the many cases and state administrative interpretations of similar state franchise and business opportunity statutes. The Code Construction Act also provides guidance.[246]

Reliance on technical interpretations by a BOA defendant is precarious in close circumstances. First, "[a] person who claims to be exempt from [the BOA] has the burden of proving the exemption."[247] Second, the statute's preamble directs that it "shall be liberally construed . . . to . . . protect persons against false, misleading, or deceptive practices in the . . . sale . . . of business opportunities."[248] A similar preamble to the DTPA has been used by the Texas Supreme Court to expand the DTPA's reach far beyond what most attorneys would have predicted thirty years ago.[249]

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245. The most useful compilation of these sources is found in the Business Franchise Guide, published by Commerce Clearing House.

246. *See* TEX. GOV'T CODE ANN. § 311.023 (Vernon 1998) (enumerating the Code's statute construction aids).

> [Courts] may consider among other matters the: (1) object sought to be attained; (2) circumstances under which the statute was enacted; (3) legislative history; (4) common law or former statutory provisions, including laws on the same or similar subjects; (5) consequences of a particular construction; (6) administrative construction of the statute; and (7) title (caption), preamble, and emergency provision.

Id.; *see also* Union Bankers Ins. Co. v. Shelton, 889 S.W.2d 278, 280 (Tex. 1994) (indicating that "a [reviewing] court must look to the intent of the legislature and must construe the statute so as to give effect to that intent").

247. TEX. BUS. & COM. CODE ANN. § 41.005 (Vernon 1994).

248. TEX. BUS. & COM. CODE ANN. § 41.002(a) (Vernon 1994); *cf.* Eye Assocs., P.C. v. IncomRx Sys. Ltd. P'ship, 912 F.2d 23, 24 (2d Cir. 1990) (reflecting on the Connecticut Legislature's intent behind passage of the state's Business Opportunity Investment Act).

> When the Connecticut [L]egislature passed the Act it sought to protect its citizens from "business opportunities" such as "chain letter" types of franchises and "worm farm companies" that sell opportunities by convincing investors that—with a modest investment—they can make $200-$300 a week with little or no work. . . .
> . . . But like drift-net fishing the Connecticut legislature intended its cast to be wide and deep so that it might cover all business opportunities, not just those of unscrupulous operators promising the miracle of millions for an hour's work.

Id.

249. *See* Melody Home Mfg. Co. v. Barnes, 741 S.W.2d 349, 354 (Tex. 1987) (noting that courts best serve the law when recognizing "that the rules of law which grew up in a remote generation may, in the fullness of experience, be found to serve another generation badly" (quoting Humber v. Morton, 426 S.W.2d 554, 561-62 (Tex. 1968))).

BOA plaintiffs will rely on the BOA preamble and this analogy. BOA defendants will counter by stressing that the "business opportunities" portion of the preamble's directive shows that the subject license, distributorship, or supply agreement is not the type of transaction the legislature intended to regulate. Close fact questions are likely to go to the jury.

IV. International Franchise Law

International franchising is outside of this Article's scope. More and more of our clients, however, do business outside of the United States. They need to be aware that many foreign countries, and many provinces and states within foreign countries, regulate franchising.[250] Additionally, foreign countries' laws concerning trademarks, anti-trust, distribution, and a host of specific laws may be applicable.

It is particularly important to obtain trademark registrations in target countries before contacting anyone concerning franchising in those countries. In the absence of such registration, someone else may obtain a registration on the client's trademark in the target country and thus prevent the client from using the trademark in that country.[251]

V. Litigation Issues

A. *Deceptive Trade Practices Act*

Successful franchisees want freedom from franchisor control and royalties. Unsuccessful franchisees want recovery of their franchise fee, royalties, total investment, and lost opportunity costs, all trebled, plus attorney's fees—and to tell everyone how rotten the franchisor is. For a franchisee to prevail in a Texas DTPA[252] action, the franchisee must prove consumer status, a

250. *See generally* Alex S. Konigsberg, International Franchising (2d ed. 1996) (providing a thorough background on international franchising); Larry Weinberg & Geoffrey B. Shaw, *A Practical Road Map to Entering the Canadian Market*, Franchise L.J., Fall 2004, at 63 (noting the practical differences between the Canadian and American franchising landscapes).

251. *See* Person's Co. v. Christman, 900 F.2d 1565, 1567 (Fed. Cir. 1990) (affirming a lower court's opinion that a Japanese company was not entitled to cancellation of the appellee's registration of a trademark because the company had not established rights to use the mark under United States law).

252. Tex. Bus. & Com. Code Ann. §§ 17.041–17.063 (Vernon 2002).

DTPA violation, producing cause, and damages.[253] To qualify as a consumer (1) "the plaintiffs must have sought or acquired goods or services by purchase or lease," and (2) "the goods or services purchased or leased must form the basis of the complaint."[254]

A business opportunity purchaser or franchisee is typically held to be a DTPA consumer on the implicit or express finding that goods and services are part of the franchise relationship represented by the seller.[255] Other cases, however, focus on the bundle of intangible rights granted—for example, a trademark license or distributorship right—and find the inevitable transfers of goods and services to be merely incidental, and thus the transaction is not covered by the DTPA.[256] DTPA analysis considers the substance of the transaction as represented by the seller and the matters about which the buyer complains, rather than the embodiment of the final contract, which would be a Business and Commerce Code analysis.

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253. *Id.* § 17.50.

254. Melody Home Mfg. Co. v. Barnes, 741 S.W.2d 349, 351-53 (Tex. 1987).

255. *See* Tex. Cookie Co. v. Hendricks & Peralta, 747 S.W.2d 873, 877 (Tex. App.—Corpus Christi 1998, pet. denied) (holding that a franchise agreement involved the transfer of "goods or services" within the meaning of the DTPA); Bonanza Rests. v. Uncle Pete's, Inc., 757 S.W.2d 445, 446-47 (Tex. App.—Dallas 1988, writ denied) (affirming the result from the trial court, in which the jury found that Bonanza's sale of a franchise was a "knowing, unconscionable, and a producing cause of damage to [the franchisee] within the meaning of the DTPA"); Wheeler v. Box, 671 S.W.2d 75, 78 (Tex. App.—Dallas 1984, no writ) (holding that the evidence was sufficient to show that the appellees were consumers within the meaning of the DTPA); Woo v. Great Southwestern Acceptance Corp., 565 S.W.2d 290, 298 (Tex. App.—Waco 1978, writ ref'd n.r.e.) (concluding Woo should have recovered the purchase price paid for a distributorship under the DTPA).

256. *See* Meineke Disc. Muffler Shops, Inc. v. Jaynes, 999 F.2d 120, 125 (5th Cir. 1993) (concluding the Jaynes were not consumers under the DTPA because the complaint focused on the validity of an intangible property right); Americom Distrib. Corp. v. ACS Communications, Inc., 990 F.2d 223, 227 (5th Cir. 1993) (holding that a claim based on the suspension of a distributorship, rather than on a defect in purchased goods, is not a valid DTPA claim); Crossland v. Canteen Corp., 711 F.2d 714, 721 (5th Cir. 1983) (concluding that "the franchise, as an intangible commercial contract right, was not a 'good' or 'service' within the meaning of [the DTPA]"); Brock v. Baskin Robbins, USA, Co., No. 5:99-CV-274, 2003 WL 21309428, at *5 (E.D. Tex. Jan. 17, 2003) (holding that the franchisees purchased an intangible right with collateral goods and services and, thus, were not DTPA consumers); Fisher Controls Int'l, Inc. v. Gibbons, 911 S.W.2d 135, 139 (Tex. App.—Houston [1st Dist.] 1995, writ denied) (holding that qualifying services accompanying the purchase of a representative agreement were incidental to the transaction and thus the transaction was not covered under the DTPA).

Privity is not required for DTPA consumer status.[257] Thus, the franchisor's officers and directors may be liable to the franchisee for their representations because many Section 17.46(b) representations do not require intent to deceive or knowledge of their falsity.[258] A seller's standard sales representations, which may have been truthful for all prior franchisees, may be DTPA violations if they do not prove true for a particular unlucky plaintiff-franchisee.[259] Most common-law defenses are inapplicable to DTPA actions.[260]

Although the DTPA's Section 17.46(b)(24) prohibition against failing to disclose material information requires a showing of intent,[261] it may be persuasively asserted against franchisors who fail to provide a disclosure statement if presented to the jury together with the FTC Rule's disclosure requirements.[262] "Section 436.1 provides that the failure to furnish a prospective franchisee with the specified information is an unfair or deceptive act or practice within the meaning of the Federal Trade Commission Act. The

257. *See* Flenniken v. Longview Bank & Trust Co., 661 S.W.2d 705, 707 (Tex. 1983) (stating that privity is not a consideration when determining consumer status).

258. *See* Concorde Limousines, Inc. v. Moloney Coachbuilders, Inc., 835 F.2d 541, 544 (5th Cir. 1987) (commenting that "sellers are strictly liable for misleading statements about price"); Allais v. Donaldson, Lufkin & Jenrette, 532 F. Supp. 749, 751-52 (S.D. Tex. 1982) (noting that the DTPA is a strict liability statute); Pennington v. Singleton, 606 S.W.2d 682, 689-90 (Tex. 1980) (commenting on the legislature's requirement of intent for four of the subdivisions of Section 17.46(b)).

259. *See Pennington*, 606 S.W.2d at 689 (commenting that four of the DTPA's laundry list provisions require proof of intent or knowledge, while twenty do not).

260. *See* First Title Co. of Waco v. Garrett, 860 S.W.2d 74, 77-78 (Tex. 1993) (noting that generally waivers of consumer protection are against Texas public policy and therefore void and unenforceable); Alvarado v. Bolton, 749 S.W.2d 47, 48 (Tex. 1988) (holding that the doctrine of merger does not defeat a DTPA action); Weitzel v. Barnes, 691 S.W.2d 598, 599-600 (Tex. 1985) (indicating that oral representations can be admissible in a DTPA claim as a basis for that claim). *But see* TEX. BUS. & COM. CODE ANN. § 17.42(b)-(c) (Vernon 2002) (outlining when a waiver under the DTPA is valid).

261. *See* TEX. BUS. & COM. CODE ANN. § 17.46(b)(24) (Vernon 2002) (prohibiting the failure to "disclose information concerning goods or services which [were] known at the time of the transaction if such failure to disclose . . . was intended to induce the consumer into a transaction into which the consumer would not have entered had the information been disclosed"); Freeman v. Greenbriar Homes, Inc., 715 S.W.2d 394, 397 (Tex. App.—Dallas 1986, writ ref'd n.r.e.) (noting that what is now Section 17.46(b)(24) requires a showing of intentional misconduct on the seller's part).

262. *See* Century 21 Real Estate Corp. v. Hometown Real Estate Co., 890 S.W.2d 118, 125 (Tex. App.—Texarkana 1994, writ denied) (noting that "[t]he DTPA applies to an act or practice prohibited by an FTC rule or regulation").

DTPA applies to an act or practice prohibited by an FTC rule or regulation."[263]

There will often be a dispute concerning whether the representation was nonactionable "puffing" or a representation of material fact.[264] The discussion in *Autohaus, Inc. v. Aguilar*[265] concerning "the levels of the knowledge of the buyer and seller,"[266] "whether or not [a representation's] correctness is a matter of which either of the parties can judge as well as the other, upon which the buyer can, and may, reasonably be expected, in the exercise of ordinary diligence, to have formed his owned opinion,"[267] and "whether the statement made is specific enough to be an actionable misrepresentation under the DTPA"[268] will be used to attack franchisor representations that fail to come true. Scienter is not needed for a sale to be unlawful if it is unconscionable.[269]

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263. *Id.* (citations omitted); *see also* Rodopoulos v. Sam Piki Enter., Inc., 570 So. 2d 661, 665 (Ala. 1990) (holding that the FTC regulations were admissible in a fraud case when considering the defendant's duty to the plaintiff). The court found that, "[u]sing 16 C.F.R. § 436.1 as the standard of care . . . there was sufficient evidence from which the jury could conclude that the defendants breached their duty to the plaintiffs." *Id.* at 666; *see also* Morgan v. Air Brook Limousine, Inc., 510 A.2d 1197, 1206 (N.J. Super. Ct. Law Div. 1986) (stating that "[a] franchisor's failure to comply with the Rule, such failure deemed by the Rule to be an unfair or deceptive act or practice, is an affirmative act or practice in violation of § 2 of the [New Jersey Consumer Fraud Act]"); Tex. Cookie Co. v. Hendricks & Peralta, 747 S.W.2d 873, 877 (Tex. App.—Corpus Christi 1988, writ denied) (noting that the appellant's violation of the rule was used as a basis for finding an independent DTPA violation). *But cf.* Symes v. Bahama Joe's, Inc., No. 87-0963-Z, 1988 U.S. Dist. LEXIS 9611, at *13-15 (D. Mass. Aug. 12, 1988) (noting that a violation of FTC regulations does not necessarily lead to a violation of the Massachusetts General Laws chapter 93A); LeBlanc v. Delt Ctr., Inc., 509 So. 2d 134, 137 (La. Ct. App. 1987) (agreeing with the trial court "that the failure to comply with the FTC disclosure regulations did not constitute an unfair trade practice" under Louisiana law).

264. Prudential Ins. Co. of Am. v. Jefferson Assocs., Ltd., 896 S.W.2d 156, 163 (Tex. 1995) (concluding that statements by the seller that a building was "superb," "super fine," and "one of the finest little properties in the City of Austin" were "puffing" and opinion rather than misrepresentations of material fact).

265. 794 S.W.2d 459 (Tex. App.—Dallas 1990, writ denied).

266. Autohaus, Inc. v. Aguilar, 794 S.W.2d 459, 463 (Tex. App.—Dallas 1990, writ denied).

267. *Id.* (quoting U.S. Pipe & Foundry Co. v. City of Waco, 108 S.W.2d 432, 436-37 (Tex. 1937)).

268. *Id.* at 464.

269. *See* Chastain v. Koonce, 700 S.W.2d 579, 583 (Tex. 1985) (noting that "a consumer need only prove that he was taken advantage of to a grossly unfair degree"); Griffith v. Porter, 817 S.W.2d 131, 136 (Tex. App.—Tyler 1991, no writ) (commenting that "[t]here is no requirement that [the defendant] 'intended to take advantage of the consumer or acted with knowledge or conscious indifference'").

The DTPA's 1995 amendments substantially affected its impact on franchising. First, consumer waivers of the DTPA are now possible.[270] Second, the "gross disparity" method of showing unconscionability was deleted.[271] Third, it is unclear whether a franchisee's total real estate build-out and lease obligation and full franchise term royalty obligation will be considered in determining the "total consideration by the consumer" with respect to the DTPA's $100,000 and $500,000 transaction limits.[272] Finally, the several new limitations on damages may lessen the franchisee's recovery.[273] Breaches of representations of performance sound only in contract, not under the DTPA, and thus reduce the DTPA's reach.[274]

A franchise agreement with properly drafted disclaimers, merger clauses, and few promises may eliminate many DTPA claims and fraud.[275] Nevertheless, negligent misrepresentation, DTPA, and

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270. *See* TEX. BUS. & COM. CODE ANN. § 17.42 (Vernon 2002) (providing for how a consumer can waive consumer protection under the Act).

271. *See* Act of June 8, 1995, 74th Leg., R.S., ch. 414, 1995 Tex. Gen. Laws 414 (deleting the language from the code defining an "unconscionable action or course of action" as, *inter alia*, an act that "results in a gross disparity between the value received and consideration paid, in a transaction involving transfer of consideration").

272. *See* TEX. BUS. & COM. CODE ANN. § 17.49 (Vernon 2002) (providing exemptions for transactions over $100,000 and $500,000 under certain conditions).

273. *See* RICHARD M. ALDERMAN, TEXAS CONSUMER LAW: CASES AND MATERIALS 223 (6th ed. 2003) (noting that prior to 1995, the DTPA permitted recovery of actual damages). The current version of the law, however, only allows recovery of economic damages. TEX. BUS. & COM. CODE § 17.50(b)(1) (Vernon 2002). If the violating conduct was committed "knowingly," the consumer may also recover damages for "mental anguish." *Id.*

274. *See* Crawford v. Ace Sign, Inc., 917 S.W.2d 12, 15 (Tex. 1996) (holding that nonperformance of a contract providing for advertising in a telephone directory did not give rise to a DTPA cause of action); Ashford Dev., Inc. v. USLife Real Estate Servs., 661 S.W.2d 933, 935 (Tex. 1983) (noting that "[a]n allegation of a mere breach of contract, without more, does not constitute a 'false, misleading or deceptive act'").

275. *Cf.* DRC Parts & Accessories, L.L.C. v. VM Motori, S.P.A., 112 S.W.3d 854, 858-59 (Tex. App.—Houston [14th Dist.] 2003, pet. denied) (holding that a franchise agreement's unambiguous language blocked a fraud claim); C & A Invs., Inc. v. Bonnet Res. Corp., 959 S.W.2d 258, 264 (Tex. App.—Dallas 1997, pet. denied) (affirming the trial court's ruling for Bonnet because C & A knew the alleged misrepresentations might be inaccurate). C & A alleged fraud because it relied on statements by the respondent that a loan C & A was to purchase was performing. *Id.* at 259-60. C & A, however, contracted to not rely on any of Bonnet's statements during the purchasing process. *Id.* at 264; *cf. also* High v. McLean Fin. Corp., 659 F. Supp. 1561, 1567 (D.D.C. 1987) (refusing to grant a motion to dismiss in part because the complaint alleged the defendant's employees told the plaintiffs they met the defendant's loan criteria); Fisher Controls Int'l, Inc. v. Gibbons, 911 S.W.2d 135, 142 (Tex. App.—Houston [1st Dist.] 1995, writ denied) (noting that "[w]hen

fraud in the inducement attacks may sometimes get to the jury.[276] On bad facts, a breach of duty of good faith claim may get to the jury.[277] Additionally, representations made after the agreement was signed may not be barred by the contract.[278]

B. *Business Opportunity Act*

The Texas Attorney General (AG) has authority to enforce the BOA.[279] The AG opens a file when a business is identified as a likely noncompliant franchise or business opportunity seller by the annual joint FTC/state attorney generals' sweep or in response to consumer complaints.[280] The AG then typically sends a polite inquiry letter to the target business. Reputable and compliant busi-

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experienced executives represented by counsel voluntarily sign a contract whose terms they know, they should not be allowed to claim fraud in any earlier oral statement inconsistent with a specific contract provision"); Airborne Freight Corp. v. C.R. Lee Enters., 847 S.W.2d 289, 297 (Tex. App.—El Paso 1993, writ denied) (finding that an agreement containing cautionary language that no representations had been made about the duration of the agreement between the parties precluded the plaintiff's recovery for the defendant's termination of the agreement).

276. *See* Tex. Taco Cabana, L.P. v. Taco Cabana of N.M., Inc., 304 F. Supp. 2d 903, 911-12 (W.D. Tex. 2003) (holding that a general contractual stipulation of non-reliance only negated representations expressly excluded by the disclaimer); F.T.C. v. Minuteman Press, 53 F. Supp. 2d 248, 262-63 (E.D.N.Y. 1998) (holding a franchisor's principals individually liable for making false claims regarding profitability despite written contractual disclaimers because "a reasonable consumer could legitimately conclude that he or she was being furnished important specific earnings information . . . to assist in the decision-making process notwithstanding the general disclaimer"); Carousel's Creamery, L.L.C. v. Marble Slab Creamery, Inc., 134 S.W.3d 385, 390, 395 (Tex. App.—Houston [1st Dist.] 2004, pet. filed) (noting that a franchisee's fraud and DTPA claims went to the jury at the trial court, and sustaining the franchisee's point that the trial court should not have granted the franchisor's motion for a directed verdict on the negligent misrepresentation claim); Shell Oil Prods. Co. v. Main St. Ventures, L.L.C., 90 S.W.3d 375, 382 (Tex. App.—Dallas 2002, pet. dism'd by agr.) (noting that the court could not conclude a memorandum of intent precluded the plaintiff's fraud claims as a matter of law due to "string along fraud"). Fraud in the inducement, if proved, penetrates disclaimers in most, but not all, states.

277. *Compare Tex. Taco Cabana, L.P.*, 304 F. Supp. 2d at 911-12 (refusing to grant a motion to dismiss for failure to state a claim where the counter-plaintiff set forth facts alleging creation of a special relationship), *with* Brock v. Baskin Robbins, USA, Co., No. 5:99-CV-274, 2003 WL 21309428, at *6-7 (E.D. Tex. Jan. 17, 2003) (concluding there was no basis for a tortious interference claim where the contract gave the franchisor the absolute right to deny a transfer of the franchise).

278. Am. Commercial Colls., Inc. v. Davis, 821 S.W.2d 450, 453-54 (Tex. App.—Eastland 1991, writ denied) (noting that the respondent detrimentally relied on post-contract representations).

279. TEX. BUS. & COM. CODE ANN. § 41.303 (Vernon 1994).

280. *See supra* Part I.C (explaining federal franchise laws).

nesses can usually close the matter with a polite, comprehensive response. Reputable businesses that are covered by, but were previously unaware of, the BOA or the FTC Rule, can usually avoid trouble by politely responding with a promise of prompt compliance and, if needed, restitution.

A hostile or noncompliant response, however, makes the business a likely subject for further investigation. The AG typically pursues ten to fifteen such investigations a year. Most investigations lead to agreements by the subject businesses to make restitution and comply in the future. The AG has sued businesses for failing to comply with the BOA, taking the matter through jury verdict and judgment.[281]

A BOA cause of action requires proof that the buyer purchased a business opportunity from the seller, a BOA violation, producing cause, and damages.

A seller may not:

(1) employ a representation, device, scheme, or artifice to deceive a purchaser;
(2) make an untrue statement of a material fact or omit to state a material fact in connection with the documents and information required to be furnished to the secretary of state or purchaser;
(3) represent that the business opportunity provides or will provide income or earning potential unless the seller:
    (A) has documented data to substantiate the claims of income or earning potential; and
    (B) discloses the data to the purchaser when the representation is made; or

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281. *See* Texas v. Streiber, No. 2000-7363 (281st Dist. Ct., Harris County, Tex. July 24, 2001) (finding against Streiber on a comprehensive "laundry list"-type BOA jury question using language from the BOA, and asking "Did Ruth Streiber fail to comply with the Business Opportunity Act?"); Texas v. Colorall Techs. Inc., No. 98-CI-02701 (37th Dist. Ct., Bexar County, Tex. Nov. 14, 2000) (entering an agreed permanent injunction after an extended fight, including discovery in Florida, compelling compliance with the FTC Rule and payment of the attorney general attorney fees). How to best allocate attorney general (AG) resources is always a problem. A well-publicized investigative visit to a nefarious "sawdust-in-the-transmission" bad actor that makes the ten o'clock news will likely shut that bad actor down, but a franchiser/business opportunity bad actor may be a substantial multistate enterprise. While the AG can throw several attorneys into cases that affect tens of thousands of Texans, such as insurance overcharging, or can invest a few dozen hours to shut down a bad transmission repair shop, committing hundreds of attorney-hours to fighting a franchisor/business opportunity bad actor who has "only" wrecked a dozen or so Texas families is more problematic.

(4) make a claim or representation in advertising or promotional material or in an oral sales presentation, solicitation, or discussion between the seller and the purchaser that is inconsistent with the information required to be disclosed by this chapter.[282]

Viewed from the perspective of a "Do you find that . . . ?" jury question, these are powerful words. The plaintiff-buyer will tell the jury he risked his family by quitting his job to buy the business opportunity because he relied on the seller's salesman, the expert, who claimed "it's a good deal," "it'll be a Spinning Jenny," "it's a good location," "we'll be flexible and help you out if things get rough," and so on.[283] He then relates how the seller and the deal were awful and his family is wrecked. You represent the seller and the jury is misty-eyed as you hear, "Your witness."

There are no cases concerning whether Section 41.301 (1)'s "deceive" requires scienter. Subsections (2), (3), and (4) state strict liability prohibited acts. The parallel to securities law, with which this article began, continues. If a transaction is (1) deemed a sale of a security or business opportunity and (2) a prohibited representation is made and that representation does not later pan out, then (3) the seller is strictly liable.

What does subsection (2)'s "documents and information required to be furnished to the secretary of state or purchaser"[284] encompass? The BOA mandates and defines an acceptable disclosure statement.[285] There is no FTC ruling, however, that a BOA disclosure statement satisfies the FTC Rule's disclosure requirements. Thus, if the sale is a federal franchise or business opportunity, the FTC Rule's offering circular must be furnished to the

282. TEX. BUS. & COM. CODE ANN. § 41.301 (Vernon 1994).

283. *Cf.* Bradford v. Vento, 48 S.W.3d 749, 759 (Tex. 2001) (concluding that a statement by the respondent indicating he would "take care of" the plaintiff was too vague for the jury to consider whether it was accurate, and thus was not actionable).

284. TEX. BUS. & COM. CODE ANN. § 41.301(2) (Vernon 1994).

285. *See id.* § 41.151–41.163 (indicating what information must be contained in the disclosure statement).

purchaser.[286] As noted above, failing to provide an offering circular when required by the FTC Rule may be a DTPA violation.[287]

Whether this is the meaning of subsection (c) remains an open issue. Section 41.301(4)'s language referencing "information required to be disclosed by this chapter"[288] shows the legislature identified only the BOA disclosure statement and did not include the FTC Rule offering circular.[289] On the other hand, the FTC Rule offering circular need not be furnished to the Secretary of State, even though in some cases it is "required to be furnished to the . . . purchaser" by the FTC Rule.[290]

The BOA's disclosure requirements are poorly designed and merely provide for disclosure of mostly formal information. Thus, a BOA's prohibitions on omitting material facts[291] or making statements inconsistent with the required disclosures[292] do not provide much help to the unhappy franchisee after the fact. The BOA's requirement that financial disclosure by the seller be "updated to reflect material changes in the seller's financial condition,"[293] however, can be a basis for attack. Because a jury may find that the franchisors orally made "a statement concerning sales or earnings that may be made through the business opportunity,"[294] failure to comply with the disclosure requirements triggered by this representation may constitute a prohibited act and producing cause of

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286. *But see* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,970 (Aug. 24, 1979) (noting that several states use the Uniform Franchise Offering Circular ("UFOC") to comply with their own disclosure requirements). The FTC has determined that the UFOC provides prospective franchisees protection that is at least equal to that required by the Rule, and thus permits the UFOC to be used as an alternative. *Id.* The BOA disclosure statement, however, is inadequate to obtain similar recognition.

287. *See* Century 21 Real Estate Corp. v. Hometown Real Estate Co., 890 S.W.2d 118, 125 (Tex. App.—Texarkana 1994, writ denied) (noting that "[t]he DTPA applies to an act or practice prohibited by an FTC rules or regulation"); Tex. Cookie Co. v. Hendricks & Peralta, 747 S.W. 2d 873, 877 (Tex. App.—Corpus Christi 1988, writ denied) (noting that the appellant's claims used violation of federal law as a basis for its DTPA cause of action).

288. TEX. BUS. & COM. CODE ANN. § 41.301(4) (Vernon 1994).

289. *Id.* §§ 41.151-41.163.

290. *See id.* § 41.002(b) (directing that courts "to the extent possible shall follow the interpretations given by the Federal Trade Commission and the federal courts to [the FTC Rule]").

291. *Id.* § 41.301(2).

292. *Id.* § 41.301(4).

293. TEX. BUS. & COM. CODE ANN. § 41.156(2) (Vernon 1994).

294. *Id.* § 41.160.

damages.[295] If the franchisor provides prospective purchasers with reprints of favorable media articles, the franchisor may be found to have adopted the favorable statements made in those articles as its own.

Although the DTPA's remedies are adopted by the BOA,[296] there are several differences between a BOA and a DTPA action. While a DTPA claim is limited to goods and services transactions,[297] a BOA claim may be based on an intangible transaction such as a license. The DTPA excludes certain business consumers,[298] while the BOA does not.[299] A DTPA plaintiff must be a "consumer," but a BOA plaintiff need only be a "person."[300] Parts of the DTPA can be waived,[301] but waiver of BOA provisions is void.[302] The DTPA has its own venue provisions;[303] the BOA does not, and therefore, the general venue statutes apply.[304] The extent

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295. *See, e.g.*, Bailey Employment Sys., Inc. v. Hahn, 545 F. Supp. 62, 68-69 (D. Conn. 1982) (finding that statements about average annual sales volume and average weekly income were deceptive under the state's unfair trade practices act); Miksch v. T-Shirts Plus, Inc., No. 85AP-517, 1985 WL 4154, at *1-2 (Ohio Ct. App. Dec. 3, 1985) (concluding that a presentation to the prospective franchisee of sales, costs, and net profit ranges for six hypothetical stores was an earnings claim because it was an "oral, written, or visual representation to a prospective purchaser concerning potential sales, income, or gross or net profit" under the Ohio Business Opportunity Purchasers Protection Act).

296. *See* TEX. BUS. & COM. CODE ANN. § 41.302 (Vernon 1994) (granting a public or private right to enforce under the DTPA). "A violation of this chapter is a false, misleading, or deceptive act or practice under Section 17.46, Business & Commerce Code. A public or private right or remedy prescribed by Chapter 17, Business & Commerce Code, may be used to enforce this chapter." *Id.*

297. *See id.* § 17.45(4) (defining a "consumer," to whom the DTPA applies, as one seeking or acquiring goods or services by purchase or lease); Meineke Disc. Muffler Shops, Inc. v. Jaynes, 999 F.2d 120, 125 (5th Cir. 1993) (noting that to bring a DTPA claim, the claimant must be a consumer, and that to be a consumer, one must have sought or acquired goods or services).

298. *See* TEX. BUS. & COM. CODE ANN. § 17.45(4) (Vernon 2002) (excluding from the definition of "consumer," *inter alia*, business consumers with assets over $25 million).

299. *See id.* §§ 41.003, 41.004 (excepting certain *transactions* from BOA coverage, but applying the coverage to any "seller" of a business opportunity).

300. *Compare id.* § 17.50(a) (providing relief for consumers), *with id.* § 41.002 (providing protection for "persons against false, misleading, or deceptive practices").

301. *See id.* § 17.42 (providing that waiver of consumer protection under the DTPA without adhering to the specific requirements of waiver provisions is against public policy).

302. *Id.* § 41.009 (explaining that waiver under the BOA is against public policy, unenforceable, and void).

303. TEX. BUS. & COM. CODE ANN. § 17.56 (Vernon 2002).

304. *See* TEX. CIV. PRAC. & REM. CODE §§ 15.001, 15.002 (Vernon 2002) (providing that in the absence of venue specified by another statute, the venue provisions of this chapter apply).

to which the several DTPA limitations and settlement provisions are applicable to BOA actions is unknown. The limitation in the DTPA of "economic damages" does not apply to a tie-in statute like the BOA.[305] Thus, a BOA plaintiff can obtain full "actual damages."[306] The DTPA limitations period is two years from the bad act or its discovery.[307] Similarly, a BOA violation is a general statutory tort with a limitations period of two years from accrual of the cause of action.

Any BOA violation gives the plaintiff a platform for arguing that what happened to the franchisee was exactly the abuse this special statute was enacted to prevent. To prove anything beyond a nominal violation of the BOA due to the franchisor's failure to provide a formal disclosure statement, however, the nondisclosure must be a DTPA "producing cause" of damages.[308] Cases holding that agreements and disclaimers can defeat the proximate cause element in DTPA actions or preclude the seller's salesperson from having the real or apparent authority to bind the seller to the salesperson's representations give careful sellers an ability to create BOA defenses.

C. *Inevitable Unlawful Sales*

1. Problem

An unpleasant fact of life is that sometimes your client-franchisor's salesperson, UFOC, advertising agreement, or franchise agreement will represent or promise more than the franchisor could or did deliver to one or more franchisees. This may be discovered by an internal investigation or by receiving service of the franchisee's complaint, the state franchise regulator's or FTC's request-for-information or complaint, or notice by a regula-

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305. *See* TEX. BUS. & COM. CODE ANN. § 17.50(h) (Vernon 2002) (indicating that "if a claimant is granted the right to bring a cause of action under [the DTPA] by another law, the claimant is not limited to recovery of economic damages only").

306. *See id.* (providing that a claimant may recover actual damages under tie-in statutes).

307. *Id.* § 17.565.

308. *See id.* § 17.50(a) (allowing a consumer to maintain actions in which there is a producing cause of damages); *see also* Brown v. Bank of Galveston, Nat'l Assoc., 963 S.W.2d 511, 514 (Tex. 1998) (concluding that acts cited by the plaintiff as DTPA violations were not the producing cause of damages and thus holding no DTPA violation occurred). Further, the injury needs to be foreseeable for the act to be a producing cause. Doe v. Boys Clubs of Greater Dallas, Inc., 905 S.W.2d 472, 481 (Tex. 1995).

tor that a state's rules were not complied with.[309] Upon reviewing the facts, you may find that payment of damages or rescission is, in fact, required due to failure to timely register or failure to make timely and adequate disclosures.[310]

Franchising or promotional claims do not need to be demonstrably false to violate Section 5 of the FTC Act. The person making such claims must have a reasonable factual basis for making the claim at the time it is made.[311] Statements likely to mislead reasonable consumers are deemed "false."[312] The franchisee may also assert that your franchisor should have disclosed other material information, even if that information is not required to be included in the UFOC.[313] As a result, literally truthful promotional statements may be unlawful.

If the prospective franchisee shows its business plan, loan repayment schedule, or projections to the franchisor before the franchise agreement is signed, induces the franchisor to utter some platitude about it appearing reasonable, and the franchisee's plan fails, the franchisee may argue the franchisor's statement is the basis for

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309. *See generally* F.T.C. v. Kitco of Nev., Inc., 612 F. Supp. 1282 (D. Minn. 1985) (discussing a case in which the defendant distributed brochures that misrepresented the business opportunity's profitability).

310. *See* My Pie Int'l, Inc. v. Debould, Inc., 687 F.2d 919, 923 (7th Cir. 1982) (concluding that a franchisee's payment for the purchase of supplies from the franchisor within seven days of receiving a disclosure statement justified rescission under the Illinois Franchise Disclosure Act); Hicks v. United Snack Group, Inc., [June 1992-Dec. 1993 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 10,131 (W.D. Wash. 1992) (noting that, under the Washington Franchise Investment Protection Act, rescission is an appropriate remedy when the seller of a franchise has violated disclosure requirements).

311. *See* Jay Norris, Inc. v. F.T.C., 598 F.2d 1244, 1245-46, 1253 (2d Cir. 1979) (enforcing an order which prohibited the petitioners' claims other than those "fully and completely substantiated by a reasonable basis").

312. *See* F.T.C. v. Pantron I Corp., 33 F.3d 1088, 1096 (9th Cir. 1994) (remarking that to prevail on the "reasonableness" theory, a party must show that an advertiser did not have a reasonable basis for asserting the truth of the message); Kraft, Inc. v. F.T.C., 970 F.2d 311, 314 (7th Cir. 1992) (noting that "an advertisement is deceptive under the [FTC] Act if it is likely to mislead consumers, acting reasonably under the circumstances, in a material respect"); Hampton v. Sabin, 621 P.2d 1202, 1206-07 (Or. Ct. App. 1980) (recognizing that rescission may be based on either innocent or fraudulent misrepresentations).

313. *See* Williams v. Dresser Indus., Inc., 120 F.3d 1163, 1166-67 (11th Cir. 1997) (reviewing a case in which the respondent allegedly fraudulently induced the plaintiffs' participation as a distributor by concealing information about a pending joint venture). Because Dresser did not have a duty to disclose, the court reversed the lower court's ruling for the plaintiffs, which had ruled for Williams for over $10 million combined compensatory and punitive damages. *Id.* at 1167, 1174.

fraud, misrepresentation, promissory estoppel, and negligent representation claims.[314]

The systematic nature of a franchise system means that misrepresentations made to one particular franchisee may have been made to many franchisees. Further, these representations might still be occurring in the franchisor's ongoing sales, perhaps in many states. Those states' police power laws may override the Texas choice of law provision. These factors collectively make dealing with franchise sales misrepresentations a cause of migraines and ulcers.

2. Treatment

The strong franchise law compliance program discussed hereinafter will minimize misrepresentations in sales, but inevitably mistakes will happen. Proactive contract methods of reducing the odds of a litigation catastrophe include choice of law clauses applying Texas law to all disputes,[315] perhaps excluding the DTPA,[316] and specific disclaimers by the prospective franchisee of any reliance on non-UFOC representations of anything, particularly actual or anticipated revenues, profits, earnings, or success.[317]

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314. *See supra* note 275 (discussing misrepresentation and fraud claims).

315. *See* Tex. Taco Cabana, L.P. v. Taco Cabana of N.M., Inc., 304 F. Supp. 2d 903, 910 (W.D. Tex. 2003) (determining that Texas law applies because of the choice of law clause in the contract, and thus dismissing the claim for violation of the New Mexico Unfair Practices Act).

316. *See* Meehan v. United Consumers Club Franchising Corp., 312 F.3d 909, 912 (8th Cir. 2002) (agreeing with the trial court's ruling for the franchisor because the franchise agreement's disclaimer clause prevented the plaintiff from justifiably relying on the earnings and success rates); Century Pac. Ins. v. Hilton Hotels Corp., No. 03 Civ. 8258(SAS), 2004 U.S. Dist. LEXIS 6904, at *15 (S.D.N.Y. Apr. 20, 2004) (finding that a carve-out provision in the choice-of-law section of the franchise agreement made the New York Franchise Sales Act inapplicable). Specifically, the "carve out" provision provided: "Nothing in this section is intended to invoke the application of any franchise, business opportunity, antitrust, 'implied covenant,' unfair competition, fiduciary or any other doctrine of law of the State of New York or any other state which would not otherwise apply absent this [choice of law provision]." *Id.* at *11-12.

317. *See generally* Prudential Ins. Co. of Am. v. Jefferson Assocs., Ltd., 896 S.W.2d 156 (Tex. 1995) (concluding that an "as is" clause defeated causation elements in DTPA, fraud, and negligence claims); Genevieve A. Beck, *Who Says a Party Can't Contract Out Fraud?*, FRANCHISE LAW., Summer 2003, at 3 (commenting generally on disclaimers of reliance).

> Although the decisions are hardly uniform, under the law of most states, when a franchise agreement unambiguously states that the franchisee disclaims the existence of or reliance upon representations concerning revenues, costs, income, profit or success rates, the franchisee will not be allowed to claim later that it was induced into

When an error is discovered, franchisors commonly attempt to keep dancing so statutes of limitations, waiver, ratification, and equitable estoppel will create defenses while providing additional services to the aggrieved franchisees. This may sometimes result in avoiding potentially fatal litigation, state franchise administrator ordered rescission, or FTC action.

Circumstances that may pre-empt this delay strategy are the requirements of different registration states to offer rescission to all franchisees who did not receive effective disclosures, the problem of making proper disclosures concerning the issue to new prospective franchisees, and that some statutes of limitation or acts of ratification may not be effective until after the franchisees and state administrator have learned of the misrepresentation. Applicable state franchise laws may require a formal disclosure of the problem and a full offer of rescission to that state's franchisees on pain of personal civil and criminal liability for all persons who were aware of the problem and failed to report it to the state franchise administrator. To get applicable statutes of limitation and defenses, such as ratification, running, one may wish to do this anyway.

While attorneys have some leeway in dealing with past misrepresentations within the bounds of lawful ethical representation, they may not permit misrepresentations to be made in new sales. Regardless of practical problems caused by telling the truth to new prospective franchisees, one must insist on full and accurate disclosure. This may require an amendment to the UFOC that in turn requires filing the amended UFOC in registration states, thus alerting the state franchise administrator to the misrepresentation previously made to franchisees and possibly causing the state franchise administrator to begin action.

D. *Collateral Estoppel*

To succeed against large integrated chains and nimble independent businesses, the franchisor and its franchisees work together as a single competitive unit. The different franchisees' marquees, suppliers, store designs, and recipes are identical. The resultant cost

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entering into the franchise agreement in reliance on representations as to those matters.

Id. at 6; *see supra* Part V.A (discussing the usefulness of contracting out most misrepresentation claims).

savings, market presence, and critical mass help make the franchisees profitable. The franchisor leverages his limited capital and management resources by using identical contracts, correspondence, operating manuals, and similar items with each of its franchisees. This fact pattern creates a collateral estoppel situation.

> Relitigation of an issue will be barred by collateral estoppel if "(1) the facts sought to be litigated in the first action were fully and fairly litigated in the prior action; (2) those facts were essential to the judgment in the first action; and (3) the parties were cast as adversaries in the first action." For collateral estoppel to be invoked, it is only necessary that the party *against whom* the plea of collateral estoppel is being asserted be a party or in privity with a party in the prior litigation.[318]

This makes franchisors vulnerable to "piling on" by franchisees after a lost franchise suit. If, for example, a franchisee obtains a final, unappealable judgment against the franchisor that the franchisor's covenant not to compete is unenforceable or its trademark is unenforceable, all similarly situated franchisees will argue their facts are legally the same as those of the winning franchisee's. Thus, even if twenty franchisees sequentially lose in court, one successful franchisee can possibly destroy the franchise system.

Collateral estoppel can make otherwise isolated franchise suits "beat-the-system" cases. This pressures the franchisor to pick its fights carefully, because it cannot afford to lose even once. Suits based upon a specific franchisee's facts, such as its failure to pay royalties, do not create this problem.

VI. INTENTIONAL NOVICE FRANCHISOR

A. *The Novice Franchisor*

The typical prospective franchisor client has the following story:

> Business is so good I cannot serve everyone who wants to buy. My competitors see what I am doing and will preempt the market if I do not quickly expand. I do not have enough money and staff to do this myself, but people are lined up with cash in hand to buy franchises from me. I have to accept their $25,000 checks before someone else does and I lose my temporary advantage. I have done the hard part

318. Mower v. Boyer, 811 S.W.2d 560, 563 (Tex. 1991) (citations omitted) (quoting Eagle Properties v. Scharbauer, 807 S.W.2d 714, 721 (Tex. 1991)).

in making my small chain into a blockbuster success. Rapid expansion, paid for with up front franchise fees, must begin *now!*

The reality is that (1) before franchises are sold, a substantial additional investment of effort, changes, and money needs to be made in hiring and training for franchise sales, training, and support over and above what is required for the company's own operational needs, and even more extensive operations manuals, forms, and documents need to be prepared. Franchise legal expenses are high and will increase as long as the system is expanding. Required annual audited financial statements will cost thousands of dollars each year. Reviewing and approving each franchisee's design plans, leases, sites, and similar decisions require professional services at a cost to the franchisor; (2) initial franchises and distant franchises will be unprofitable to service; and, perhaps most importantly, (3) premature franchise sales may doom the entire enterprise.

Franchising's many hidden expenses will likely exceed income until a sufficient number of franchises are on-line and peacefully paying royalties. Until that point is reached, however, the new franchisor's cash flow is hostage to bringing in additional up-front fees from the sale of new franchises. Sustainable profitability comes from having a critical mass of happy, loyal, and successful experienced franchisees. Once that goal is achieved, the rewards can be enormous. The advantages of critical mass, specialized systems, experience, and local owners are substantial for everyone in the system. Getting there, however, is harder, riskier, and more expensive than novices realize. Many, if not most, start-up franchisors fail.

B. *The Lawyer's Role*

While knowledge of the franchise law is needed, intentional novice franchisors place an additional set of demands on their attorney. A client always knows more about his line of commerce than his attorney. The client wants the attorney to quickly and inexpensively "paper over" handshake deals. When the ink dries, the lawyers go back to their offices and the clients continue their commercial relationship. The novice franchisor client, however, is entering a new line of commerce: franchising. The lawyer, on the other hand, has structured other franchise systems, dealt with dis-

gruntled franchisees, and worked with both successful and unsuccessful franchisors; the client has none of these experiences.

This puts the lawyer in an awkward role. Is the business franchiseable? Is the client prepared to begin franchising now? What is a reasonable franchise fee? How fast should the client expand? The novice franchisor, even if an experienced and successful business person, needs business advice concerning these critical decisions. Perhaps the franchise concept needs to be refined by launching a remote company store; sales materials and a more comprehensive operations manual need to be prepared and test driven; prospects must be identified and qualified, which means turning away eager prospects with cash in hand if they are not likely to be long-term winners. The franchisor must then provide training and establish relationships with quality suppliers willing to give quantity discounts; and the list goes on. For clients doing business in their established line of commerce, it is generally inappropriate for a lawyer to give business advice. Further, the lawyer cannot slide into de facto management without creating an indefensibly high bill for "legal services" and possibly losing his protected status as a "mere" attorney. But if the lawyer does not offer sound business advice, based on experience with other franchisors, the novice franchisor may not get it at all.

There is no standard answer to this dilemma. The best a lawyer can do is be continually aware of the problem. Giving the client John Love's *McDonald's: Behind the Arches*, a book about the founding of the McDonald's restaurant chain, will increase his franchising common sense.[319]

C. *Educate the Client*

An essential tool in getting the franchisor's management team to effectively police against franchise sale misrepresentations and other violations is to educate its individuals that they may be *per-*

319. *See generally* KATHRYN L. BOE ET AL., THE FRANCHISE OPTION: HOW TO EXPAND YOUR BUSINESS THROUGH FRANCHISING (2d ed. 1987) (providing general information on franchising that might be useful to clients considering the process); JOHN F. LOVE, MCDONALD'S: BEHIND THE ARCHES (2d ed. 1995) (detailing the company's slow evolution through trial and error to focusing on only selling franchises to great prospective franchisees and then helping them succeed).

sonally liable for bad franchise sales.[320] The franchisor's principals should be counseled concerning the *personal liability of everyone and anyone who permits or makes a misrepresentation.* Any misrepresentation suit will likely include them as individual defendants.

For example, FTC enforcement actions typically make the franchisor's officers jointly and severally liable for consumer redress and civil penalties.[321] Although an individual is only liable under the FTC Act if the FTC shows "that the individual directly participated in the practices or acts complained of or that the individual had authority to control the practices or acts complained of and had some knowledge of the practices or acts,"[322] the FTC can prove knowledge "by showing that the individual had 'actual knowledge of material representations, reckless indifference to the truth or falsity of such misrepresentations, or an awareness of a high probability of fraud along with an intentional avoidance of the truth.'"[323]

While clients universally want to avoid the cost and aggravation of franchise law compliance, being public about the penalties for noncompliance, such as possible destruction of the business or personal and criminal liability, is a useful attention-getting tool.[324] An

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320. *See* United States v. Bldg. Inspector of Am., Inc., 894 F. Supp. 507, 519 (D. Mass. 1995) (finding a franchisor's president liable for the franchisor's UFOC misrepresentations because he had ultimate managerial control of the franchisor, was, or should have been, aware of the misrepresentations, and his professed ignorance of the violations and his responsibilities under the FTC Rule was not a defense).

321. *See* F.T.C. v. Value Invs., Ltd., No. 91-317-B-M2, 1994 U.S. Dist. LEXIS 19480, at *3 (M.D. La. Mar. 3, 1994) (finding franchise officers jointly and severally liable); *In re* Namer, [Aug. 1990-May 1992 Transfer Binder], Bus. Franchise Guide ¶ 9992 (Bankr. E.D. La. Apr. 8, 1991) (noting a joint and several $3 million judgment against a judgment debtor and his wholly-owned company); Franchisor to Pay $ 3,000,000 in Consumer Redress, $1,600,000 in Penalties to Settle FTC Court Action, [Feb. 1985-June 1986 Transfer Binder] Bus. Franchise Guide (CCH), ¶ 8433 (1985) (describing joint and several liability for $3 million in customer redress and $1.6 million in civil penalties for a franchisor and its officers).

322. F.T.C. v. Solomon Trading Co., No. Civ. 91-1184-PHX-SMM, 1994 U.S. Dist. LEXIS 19696, at *9 (D. Ariz. June 27, 1994).

323. F.T.C. v. Amy Travel Serv., Inc., 875 F.2d 564, 574 (7th Cir. 1989) (quoting F.T.C. v. Kitco of Nevada, Inc., 612 F. Supp. 1282, 1292 (D. Minn. 1985)).

324. *See* Dollar Sys., Inc. v. Avcar Leasing Sys., Inc., 890 F.2d 165, 176 (9th Cir. 1989) (expounding that an officer or director will be held jointly and severally liable if the corporation is found liable); F.T.C. v. Int'l Computer Concepts, Inc., No. 1:94CV1678, 1994 U.S. Dist. LEXIS 20965, at *5-6 (N.D. Ohio Oct. 24, 1994) (granting the FTC an *ex parte* temporary restraining order freezing the franchisor's assets and permitting expedited discovery);

advising lawyer should emphasize to a potential franchisor the parallels to securities law, thereby encouraging management to aggressively police franchise sales by (1) disclosing the required information in accordance with the mandated forms, deadlines, procedures, and registrations,[325] and (2) not failing to disclose material information.[326]

Lawyers should have frank discussions with their clients concerning the horrendous cost of even victorious litigation while cautioning that the expensive, wonderful franchise documentation they prepare does not guarantee victory in the courtroom. Everyone in the franchisor's organization needs to understand that walking away from half a dozen questionable franchise sales is

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Courtney v. Waring, 237 Cal. Rptr. 233, 236-37 (Cal. Ct. App. 1987) (ruling that liability can fall upon a principal officer of a franchise seller); People v. Mott, 189 Cal. Rptr. 589, 594-95 (Cal. Ct. App. 1983) (holding that a defendant who failed to provide the required disclosures committed a "willful" criminal violation because he intended to commit the act, regardless of whether he intended to violate the law); Wheeler v. Box, 671 S.W.2d 75, 76, 79 (Tex. App.—Dallas 1984, no writ) (affirming the trial court's finding officers of a business personally liable). *See generally* F.T.C. v. iMall, Inc., [1998-2000 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 11,624 (C.D. Cal. Apr. 15, 1999) (holding the franchisor's principals jointly liable with the franchisor for $4 million); F.T.C. v. Inetintl.Com, Inc., [1998-2000 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 11, 659 (C.D. Cal. Mar. 29, 1999) (ordering the franchisor's founder arrested and enjoined, and requiring him to pay $1.7 million in consumer redress); Franchise Promoter to Serve Prison Term for Conspiracy to Violate FTC Rule, [Aug. 1990–May 1992 Transfer Binder] Bus. Franchise Guide (CCH) ¶ 9773 (1991) (describing that a franchise promoter was sentenced to three years probation and fined $1.4 million in redress to consumers and $870,000 in civil penalties).

325. *See* Memorandum Concerning the Sale of Franchises from Mark H. Miller (on file with the *St. Mary's Law Journal*). A portion of the author's standard memorandum to new franchisors reads:

> The UFOC is your personal offering circular. It is for your personal protection. If anything in it is incorrect, is not completely descriptive, or if any facts that would be material to a prospective franchisee's decision to purchase are not included in it, then you and anyone else who participates or directs the sale may be personally liable to the Attorney General's Office of the relevant state, the Federal Trade Commission, and any injured franchisees who rely on it. Omissions of material facts are as deadly as inclusions of incorrect information. While I will try to include everything that is material, you need to carefully read the UFOC as if your personal liability depends on it, because it does. Using an incomplete or inaccurate UFOC is a criminal violation in some states.

Id. at 3.

326. *See* TEX. BUS. & COM. CODE ANN. § 17.46(b)(24) (Vernon 2002) (prohibiting one from failing to disclose material information if that failure was intended to induce the purchaser into a transaction that the consumer would not otherwise have entered).

preferable to being sued by one disgruntled franchisee two years down the line—even if the franchisor wins.

Letters from the franchisor's president to all sales employees, agents, and brokers; their written agreements to not make unauthorized sales claims; and other such devices may all help avoid future litigation by reducing questionable conduct. This documentation may also be admissible at trial on the issues of punitive damages, personal liability, and criminal liability.

D. *Full Disclosure*

Preparation of the offering circular makes this discussion concrete. Each UFOC item is an opportunity to interrogate the franchisor about any facts that a disgruntled franchisee could possibly assert in future litigation to put your client in a bad light. If relevant, these facts should be disclosed in the offering circular unless the state administrator orders them out.

Disclosure of embarrassing details in the UFOC almost never prevents a sale. People buy a franchise because they like its look and feel and believe they can make money with it. Disclosure of a fact in a UFOC, however, bulletproofs the franchisor against a nondisclosure suit. Explaining the UFOC as a weapon against future rebellious franchisees encourages full disclosure. If disclosure does prevent a sale, the sale should not have occurred.

To emphasize the personal responsibility of each individual involved in the sales process and to help ensure that each required step is provably taken, prepare a detailed check list describing each necessary contact, disclosure, registration, or other act for any franchise sale. The form requires that some living person in the franchisor's team separately date and sign each of the listed steps that he or she accomplishes. This process helps ensure that (1) the person who talks to the prospective franchisee, makes the offer, makes the disclosures, and signs the franchise agreement (after the ten business day waiting period, of course) is aware that he or she is personally responsible for the acts, and (2) that each requisite event has in fact been accomplished by someone who personally vouches for it. While this can be an organizational problem, it is cheap relative to the cost of just one disgruntled franchisee lawsuit.

Most new franchisors attempt to "firewall out" liabilities by creating a separate franchisor sales corporation to protect the franchisor's existing business. Such incorporation also reduces au-

dit costs.[327] This is recommended, but does not avoid personal liability or attempts to pierce the corporate veil due to the inevitable mixing of personnel, facilities, and supplies between franchisee and company store support operations.

VII. ATTORNEY LIABILITY

A. *Issue-Recognition Failure*

A barrier to entering franchise law is the potential for lawsuits against attorneys. The most apparent danger is a franchisor's claim that failure to comply with franchise law, business opportunity law, or antitrust law was due to his attorney's malpractice.

The more dangerous malpractice trap, however, is issue-recognition failure: not realizing the agreement is subject to applicable franchise or business opportunity laws. This may affect an attorney who represents a client subsequently deemed to be a franchisor,[328] or a client subsequently deemed to be a franchisee,[329] if the attorney's failure to recognize that fact causes damages to the client.

When confronted with this "standard of care" nasty fact, business attorneys commonly complain that the "franchise" and "business opportunity" definitions defy predictable application. The judiciary's response is predictable: "While we understand [the franchisor's] concern that dealerships . . . are too easily categorized as statutory franchisees, that is a concern appropriately raised to

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327. *See* N. AM. SEC. ADMIN. ASS'N, THE UNIFORM FRANCHISE OFFERING CIRCULAR GUIDELINES item 21 (2000), *available at* http://www.nasaa.org/nasaa/scripts/fu_display_list.asp?ptid=34 (requiring attachment of the financial statements). After the first year, the franchisor must be audited. Setting up a new entity to be the franchisor reduces the initial UFOC compliance cost. This will also, however, lead to problems in registration states, which may find the new, thin franchisors to be undercapitalized and require either guarantees of performance or an impound.

328. *See* Beverly Hills Concepts, Inc. v. Schatz & Schatz, Ribicaff & Kotkin, 717 A.2d 724, 728-31 (Conn. 1998) (noting the trial court's conclusion that the plaintiffs' attorney failed to recognize the client as a business opportunity seller was a substantial factor in causing damage to the plaintiff, but not reaching the issue on appeal and remanding for a new trial).

329. *See* Pyramid Controls Inc. v. Siemens Indus. Automation, Inc., 172 F.3d 516, 517-18, 520 (7th Cir. 1999) (affirming summary judgment for the franchisor because the cause accrued under Illinois law when the plaintiff's attorney "presented sufficient facts and/or circumstances to his attorney that 'reasonably indicate[d]' that the plaintiff might have a claim," and the statute of limitations had since run).

either the . . . legislature or [the] Attorney General, not to [the courts]."[330]

B. *Franchise Law Standard of Care*

The perfect franchise agreement and UFOC do not exist and would immediately be outdated if they did. They would be unaffordable and too lengthy to be saleable in any event. Practical problems as well as technical and arguable violations invariably creep into a franchisor's operations due to its own actions and the dynamic, complex laws of the numerous applicable jurisdictions. That franchisor counsel should have foreseen and prevented all future problems will be argued by unhappy franchisors who previously instructed the attorney not to run up the bill. In one Texas case, the jury found that the franchisor's attorney committed malpractice, but did not damage the franchisor due to the franchisor's other problems.[331]

Avoiding the cost and lost stomach lining of even a successful defense to such an action requires more unrequested legal research memos to the file, letters confirming verbal cautionary advice, and legal preventative maintenance letters to the franchisor and its controlling persons than other attorney-client relationships. Taking visible measures to protect oneself will also help impress the client with the need to protect himself by provably making full disclosure.

Rules have been proposed for certification of franchise attorneys.[332] While they have not been adopted, they will be urged by the malpractice plaintiff as the standard against which an attorney's work for the franchisor should be judged.

The situation is similar to a public offering of securities in which a premium is paid and paperwork is generated due to the attorney's own possible legal exposure. Further, because franchisors

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330. To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc., 152 F.3d 658, 666 (7th Cir. 1998).

331. Meinershagen v. Hughes & Luce, No. 89-13945-G (134th Dist. Ct., Dallas County, Tex. 1992). *See also* Nelson v. Dykeman, No. 09-01-226 CV, 2002 WL 538811, at *6 (Tex. App.—Beaumont Apr. 11, 2002, pet. denied) (granting summary judgment in a legal malpractice action against the franchisee's former attorney because the franchisee was unable to prove damages in the underlying case).

332. *See* Timothy H. Fine, *Model Standards for Recognition As a Specialist in Franchise Law*, FRANCHISE L.J., Summer 1984, at 5 (soliciting written comments on proposed model standards for specializing in franchise law).

operate in many states with differing and changing laws, franchisor counsel spend substantial unbillable time reading advance sheets and attending seminars to keep current.

Specialized franchise library resources are necessary. The *Business Franchise Guide* is franchise law's indispensable collection of franchise cases, statutes, regulations, interpretative opinions, and related items.[333] Most franchise attorneys belong to the American Bar Association Forum Committee on Franchising. Its published materials and its *Franchise Law Journal* are excellent. A network of experienced franchise attorneys to call on when questions outside of your expertise arise is needed.

C. *Franchisor Counsel Liability to Franchisees*

Claims by state regulators and adversely affected franchisees present more danger. The franchisee-plaintiffs, for example, might allege that the defendants negligently prepared the franchise statement, and that the statement failed to disclose material information known to the defendants but not the plaintiffs.[334] Indeed, the attorney's knowledge about the purpose of his work product establishes whether there is a duty to disclose information to those whose conduct has been influenced by that work-product.[335] This effectively applies the "due diligence" standard required of counsel in the preparation of securities disclosure documents to franchise counsel.[336]

> Every person who directly or indirectly controls a person liable under [the subject act], every partner in a firm so liable, every princi-

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333. The *Business Franchise Guide* is a three-ring binder set published by Commerce Clearing House. *See also generally* ROBERT L. PURVIN, JR., THE FRANCHISE FRAUD: HOW TO PROTECT YOURSELF BEFORE AND AFTER YOU INVEST (1994) (discussing the history of franchises).

334. *See, e.g.*, Courtney v. Waring, 237 Cal. Rptr. 233, 239 (Cal. Ct. App. 1987) (alleging that the defendants prepared false and misleading documents to influence the plaintiffs' conduct); Plaintiff's Sixth Amended Original Petition at ¶¶ 96-106, Carousel's Creamery, L.L.C. v. Hankamer, Cause No. 2000-22503-A (55th Dist. Ct., Harris County, Tex. Sept. 1992) (alleging negligent and intentional misrepresentation against the defendants, who included Hankamer's attorneys and accountants).

335. *See Courtney*, 237 Cal. Rptr. at 239 (noting that "[i]t is the attorney's knowledge regarding the purpose of his work product which . . . establishes a duty to those whose conduct has been influenced).

336. *See generally* Erik B. Wulff, *Is Franchisor Counsel Subject to Due Diligence Obligations? An Analytical Response*, FRANCHISE L.J., Spring 1985, at 3 (discussing whether franchisors' attorneys have due diligence obligations in connection with offering circulars).

> pal executive officer or director of a corporation so liable, every person occupying a similar status or performing similar functions, every employee of a person so liable who materially aids in the act or transaction constituting the violation, are also liable jointly and severally with and to the same extent as such person, unless the other person who is so liable had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability is alleged to exist.[337]

Similar language is found in the franchise statutes of Illinois, Maryland, Michigan, New York, North Dakota, Oregon, Rhode Island, South Dakota, and Wisconsin.[338]

Franchise and business opportunities laws' prohibition against a "material misrepresentation or omission" is similar to the Section 10(b)(5)[339] language that has been used to subject attorneys involved in the preparation of false or misleading securities offerings to personal joint and several liability.[340]

> The lawyer for the issuer plays a unique and pivotal role in the effective implementation of the securities laws. As a result, special duties are imposed on the lawyer . . . .

The duty of the lawyer includes the obligation to exercise due diligence, including a reasonable inquiry, in connection with responsibilities he has voluntarily undertaken.[341]

Some states use a "balancing test" when considering "the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between

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337. CAL. CORP. CODE § 31302 (Deering 1999).

338. 815 ILL. COMP STAT. 705/26 (2004); MD. CODE ANN., BUS. REG. § 14-227 (2004); MICH. COMP. LAWS § 445.1532 (2004); N.Y. GEN. BUS LAW § 691 (McKinney 2004); N.D. CENT. CODE § 51-19-03 (2003); R.I. GEN. LAWS § 19-28.1-5 (2004); S.D. CODIFIED LAWS § 37-5A-6 (Michie 2004); WIS. STAT. ANN. § 553.51 (West 2003).

339. 15 U.S.C. § 78j(b) (2004).

340. *See* S.E.C. v. Frank, 388 F.2d 486, 489 (2d Cir. 1968) (noting that "[a] lawyer has no privilege to assist in circulating a statement with regard to securities which he knows to be false simply because his client has furnished it to him"). *See generally* Joseph Reece, Comment, *Attorneys Beware: Increased Liability for Providing Advice to Corporate Clients Issuing Securities*, 20 AKRON L. REV. 519 (1987) (describing the travails of attorney exposure to the securities laws).

341. Felts v. Nat'l Account Sysm. Ass'n, 469 F. Supp. 54, 67 (N.D. Miss. 1978). The author does not urge that securities standards be applied to UFOCs. The point is that such arguments are in existence, and the cautious franchisor attorney should be aware of that fact.

the defendant's conduct and the injury, and the policy of preventing future harm."[342] Further, intended third party beneficiaries may not require privity of contract to have a claim against the franchisor's attorney.

Securities attorneys may refuse to include in a securities offering circular claims that a client instructs be included or decline to continue the representation if the claims or the client do not pass the smell test. Likewise, when a client-franchisor's story particularly reeks, it is not unheard of for the attorney preparing the UFOC to confirm the UFOC's contents. Such acts of self-preservation are motivated in part by fear of being sued or disciplined for participating in the preparation of a deceptive offering circular. While, as a general statement, attorneys may not assist in fraudulent transactions, the duties, dangers, and risks are more specific and apparent when preparing a franchise or a securities offering circular.

D. *Sarbanes-Oxley*

Attorneys who directly or indirectly deal with securities laws or the SEC are subject to the Sarbanes-Oxley Act.[343] Many attorneys who are subject to these rules do not consider themselves securities lawyers. Generally, the new SEC rules require that (1) if an attorney has credible evidence upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation[344]

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342. Lucas v. Hamm, 364 P.2d 685, 687 (Cal. 1961); *see also* Fickett v. Superior Court of Pima County, 558 P.2d 988, 990 (Ariz. Ct. App. 1976) (citing essentially the same test recited in *Lucas*).

343. *See* Sarbanes-Oxley Act of 2002 § 307, Pub. L. No. 107-204, 116 Stat. 745 (requiring the SEC to enact rules for investor protection and in the public interest that apply to attorneys appearing before the SEC).

344. *See* TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) (providing the generally accepted definition of "material").

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.

Id.

of any United States law or fiduciary duty has occurred, is ongoing, or is about to occur, (2) then the attorney has a duty to "report up the ladder" to remedy the perceived problem.[345]

There is potential for mischief due to the interaction of the Sarbanes-Oxley rules and franchise law. The vast majority of violations of federal and state franchise law are unintentional and between fully consenting businesses. In many lines of commerce sellers do not consider themselves to be franchisors and buyers do not consider themselves to be franchisees, and noncompliance with the FTC Rule and state franchise and business opportunity laws is the norm. Even if a business awakens to being within these laws' scope, absent multiple complaints there is only a remote chance that the FTC or state regulators will act.

Nevertheless, some of these players are public companies. A franchise attorney's work for an SEC reporting company may or may not be held to comprise "appearing and practicing" before the SEC "in the representation of an issuer." Acknowledged franchisors sometimes attach their UFOC as supporting documentation to SEC filings. As previously discussed, when a franchise law violation is discovered, sometimes franchisors or their attorneys fix the problem on a going forward basis—i.e., all new sales—while turning a blind eye toward prior violations in the hope that attrition and the statute of limitations will cure the problem. Sarbanes-Oxley could arguably impose a burden on attorneys for such businesses to either report franchise law violations that previously would have been discretely ignored, or to possibly be personally liable for not reporting them. While these are worrisome musings, the author of this paper has no Sarbanes-Oxley expertise. The sole intent here is to raise a yellow flag.[346]

VIII. CONCLUSION

This Article's focus on franchising's problems should not obscure that there is good, honest money to be made as a franchisor, fran-

345. *See* Sarbanes-Oxley Act of 2002 § 307, Pub. L. No. 107-204, 116 Stat. 745 (mandating that the rules enacted by the SEC meet these minimum standards).

346. *See generally* Byron F. Egan, *Sarbanes-Oxley Overview*, *in* STATE BAR OF TEX., 2ND ANNUAL ADVANCED IN-HOUSE COUNSEL COURSE ch. 8 (2003), *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=220 (providing a general overview of Sarbanes-Oxley).

chisee, or the attorney for either party. Franchising's utility as a business tool is proven by driving through any city and observing its many successful franchises. If franchising is approached intelligently, it can be a successful endeavor for all concerned.

For educational purposes only. Exceptions and variations are not shown.

ATTACHMENT A
DISTRIBUTION LAW STATUTES*

STATE	FRANCHISE		BUSINESS OPPORTUNITY		RELATIONSHIP
	REGISTRATION	NO. REG.	REGISTRATION	NO. REG.	
FEDERAL		X		X	
ALASKA			X		X
ARKANSAS					X
CALIFORNIA	X		X		X
CONNECTICUT			X		X
DELAWARE					X
FLORIDA			X		X
GEORGIA				X	
HAWAII	X				X
ILLINOIS	X		X		X
INDIANA	X		X		X
IOWA			X		X
KENTUCKY			X		X
LOUISIANA				X	
MAINE			X		
MARYLAND	X		X		
MICHIGAN	X		X		X
MINNESOTA	X		X		X
MISSISSIPPI					X
MISSOURI					X
NEBRASKA					X
NEW HAMPSHIRE			X		
NEW JERSEY					X
NEW YORK	X				
NO. CAROLINA			X		
NO. DAKOTA	X				X
OHIO				X	
OKLAHOMA			X		
OREGON		X			
RHODE ISLAND	X				
SO. CAROLINA			X		
SO. DAKOTA	X		X		X
TEXAS			X		
UTAH			X		
VIRGINIA	X			X	X
WASHINGTON	X		X		X
WISCONSIN		X			X

* This chart is for educational purposes only, and does not show minor variations and exceptions. The specific statute of each state should be consulted.