Avoiding the Accidental Franchise: Best Practices for Structuring Licenses or Distribution Agreements

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The Inadvertent Franchise: Avoiding the Broad Reach of Franchise and Business Opportunity Laws

April 16, 2014

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Discussion Points:

- What is a franchise?
- Strategies for drafting licenses and distribution agreements to avoid inadvertent franchises
- Why does franchise status matter?
- Can a commercial arrangement be both a franchise and an employment relationship?
- Roadmap for complying with franchise sales laws
- Roadmap for comply with franchise termination laws
- Common issues in franchise relationships
- Q&A
What is a franchise, and why does it matter?
Why Franchise Status **Matters:**

- Franchises are subject to extensive regulation that non-franchise licensors bypass
  - Federal and state franchise laws
  - “Front end” and “back end” franchise laws
- Franchisors that are not public companies must disclose their financial statements publicly
- Costs/delays of regulatory compliance
- Non-franchise licensing arrangements
  - Private consensual relationships
  - No “front end” or “back end” laws regulating how relationships are formed or may end
Legal Consequences: Statutory Remedies – Franchise Sales Laws ("Front End Laws")

- Damages
- Injunctive relief
- Rescission
- Potential personal liability
- Criminal prosecution = felony
- Administrative agency remedies including restitution, asset freeze, C&D
- Attorneys fees
Legal Consequences: Statutory Remedies – Franchise Termination Laws – “Back End Laws”

- Damages (some states treble damages or award lost profits)
- Potential personal liability
- Inventory repurchase
- Injunctive relief
- Attorneys fees

Franchise
License vs. Franchise

- By legal definition, every franchise is a trademark license.

\[ F = TM \]

- But not every trademark license is a franchise

\[ TM \neq F \]
A franchise is a creature of statute and essentially a 3-legged stool:

- **Significant Assistance/Control**
- **Trademark**
- **Marketing Plan**
- **Required Fee**
- **Community of Interest**
First Prong/Leg

- Definitional variations
  - “substantial association” with a licensor’s TM
  - TM license

- Defacto licenses
  - “Smith’s Appliances, an authorized Brand X Service Center”
  - ABC, a member of the Oracle Partner Network (displayed with logo)
  - Branded products or services account for a significant % of the independent operator’s overall sales

- Licensor’s quandary
Middle Prong/Leg

- Definitional variations – vary by jurisdiction
  - Substantial assistance/significant control
  - “Marketing plan”
  - Community of interest
- No minimum number of facts must co-exist
- Most subjective of the 3 definitional prongs/legs
- Licensor’s quandary
Tests for “substantial assistance/significant control” & “marketing plan prescribed in substantial part” = alike
- Focus on training, marketing support, control over reps/warranties to customers, limits on collateral services to customers, lead generation support
- “Normal” routines ≠ marketing plan
- Technical vs. operational/marketing training + support

“Community of interest” in marketing goods/services
- Licensor/licensee: common source of revenue; significant “continuing financial interest”
- Interdependence: “over a barrel”
Third Prong/Leg

- Captures all sources of revenue to licensor or an affiliate for the distribution or licensing rights
  - Nominal minimum threshold ($500/year generally)
  - Lump sum, installment or recurring
  - Fixed, fluctuating or percentage fee
- Bona fide wholesale price exception for goods bought for resale (inventory)
- Optional vs. required payments
- Ordinary business expenses
- Direct and indirect fees
- Importance of money flow (compare commissions)
Business Opportunity (Bus/Op) Laws (aka “seller assisted marketing plans”)

- Goods/Services
- $$$ to promoter (amount varies)
- Start, maintain or operate business
- Representations

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Business Opportunity (Bus/Op) Laws (aka “seller assisted marketing plans”)

- Less costly investments
- Triggering representations
- Miscellaneous exemptions and exclusions
  - Entrance fee under $500
  - Federal or state TM registration
  - Some states exclude operators already in business or same line of business
  - Compliance with federal franchise sales laws
- Similar regulatory system
  - “Front end” laws
  - No Bus/Op “back end” laws
What Parties Call the Arrangement is … Irrelevant

- License
- Dealership
- Distributorship
- Strategic alliance
- Marketing affiliation
- Joint Venture
- Affiliate Program
- Co-Branding Partner
- Member
- Partner
No Defense to Statutory Violations if …

- Violation is inadvertent
- Violation is unintentional
- Seller lacks knowledge of the law
- Competitors don’t comply
- Buyer agreed to waive compliance
Top 10 Excuses Why an Agreement Can’t be a Franchise

10. “Everyone else in our industry does it this way”
9. “We grant licenses, not franchises”
8. “We’ll just call it something else”
7. “We’re partners, really”
6. “We don’t tell them how to operate their business”
Top 10 Excuses Why an Agreement Can’t be a Franchise

5. “They use their own trade name, not ours”
4. “They buy products from our affiliate, not us”
3. “They sell other products/services besides ours”
2. “We never intended it to be a franchise”
1. “We didn’t know about the law when we signed the contract”
Strategies for drafting licenses and distribution agreements to avoid inadvertent franchises
How Do Accidental Franchises Happen?

- “Follow the money flow”
- “Nickels and dimes”
- “Sunken investments”
- “When is a fee truly optional?”
How Do Accidental Franchises Happen?

- “Know-how” vs. “how to”
- Debunking joint ventures as hidden franchises
- Ubiquitous branding – everyone wants to associate in some capacity (distributor, licensee, franchisee, co-branding partner) with a well-recognized brand for the “halo effect”
Ubiquitous Branding
Ordinary Distributorship or Licenses vs. Franchise or Business Opportunity?

- Examine contract terms (oral or written)
- Examine parties’ course of dealing
- Examine if “optional” requirements are truly optional
- Examine if seller promises to assist distributor in finding outlets, accounts or buy-back inventory
- Examine if supplier promises that the distributor’s income from distribution rights will exceed distributor’s initial investment
- Examine if supplier promises that income from distribution rights will exceed purchases of inventory
Ordinary Distributorship or Licenses vs. Franchise or Business Opportunity?

- Remember: titles are irrelevant
- Contract disclaimers and waivers are void
- Distributor must be independent contractor, not employee (… but wait ….)
License vs. Franchise

- Television network & affiliate stations
- Technology alliances
- Value added resellers
- ASPs
- Manufacturing licenses
- Patent licenses
- Major airlines and commuter links
“Know-How” Licenses vs. “How To” Controls

- Technical “know-how” license often does not involve significant assistance or control over the *entire method of operation*
- Marginal vs. significant effect
- Significance depends on degree of licensee’s *reliance*
- Reliance depends on licensee’s relative *sophistication*
Characteristics of a Product Distributorship

- Supply arrangement
- Independent contractor – wholesale buyer
- Specific branded products
- Often allocation of territories (need not be exclusive), customers and/or trade channels
- Trademark identity - branded product sales
  - Uniforms
  - Delivery vehicles
- Restrictions on sales of directly competitive products
Characteristics of a Product Distributorship

- National accounts and merchandising support programs
- Sales quota or “best efforts”
- Requirements for handling, storing, selling, delivery and merchandising inventory
- Customer support
- Warranty requirements
- Minimum inventory purchases
- Supplier may provide marketing support with or without contributions from distributor
Ordinary Distributorship vs. Franchise vs. Business Opportunity?

- Multi-line distributors – 20% rule
  - “Fractional franchise” definitional exclusion from most, but not all “3-prong” states
  - But there may not be any exclusion in “2-prong” states (8-10 states protect arrangements without regard for whether a required fee is paid or not)

- If any statutory element is missing, the franchise or bus/op statute does not apply
  - It does not matter how expansively the other definitional elements exist

- Distributor as independent contractor vs. employee
Distributorship vs. Franchise
Dealership vs. Franchise

- Required vs. optional payment
- Payments to licensor vs. third party
- Bona fide wholesale price exemption
- Minimum payment
- 6 month rule
- “Follow the money flow”
- “Nickels & dimes” – *To-Am Equip. Co., Inc. v. Mitsubishi Caterpillar Forklift America, Inc.* 152 F.3d 658 (7th Cir. 1998)
A closer look at why franchise status matters ...
The Primary Concerns of the Inadvertent Franchise

- Federal regulations and state law treat the franchise relationship differently than most other contractual relationships, engrafting protections to the licensee of the trademark beyond the relationship contained in the written contract.

- Purchasers of a franchise may be granted broader legal rights than originally intended.

- Failure to comply with the franchise laws can expose a company and its officers, directors and employees to significant legal liability.
Consequences under the FTC Rule

- A business relationship determined to be a franchise requires a pre-sale disclosure document.
- Failure to comply with this requirement is an “unfair and deceptive” trade practice under Section 5 of the FTC Act and can subject the company to enforcement proceedings.
- The FTC is empowered to levy fines and recover monies on behalf of aggrieved franchisees as consumer redress.
- The FTC may require an offer of rescission to aggrieved franchisees.
- The FTC may require the entry of a consent decree which may limit future activities.
Consequences under the State Disclosure and Registration Laws

- Unlike the FTC Rule, state laws typically grant an aggrieved individual a private right of action.
- The individual may seek damages or rescission.
- The state agency responsible for enforcement may seek an injunction prohibiting further violations, prohibiting the franchisor from doing business in the state, denying or revoking franchise registration, demanding escrow or impoundment of franchise fees payable, impose civil or criminal sanctions.
Consequences under State Relationship Laws

- If a franchisor attempts to cancel, terminate, or non-renew or impair transfer of a franchise in violation of a state law, the franchisee may seek damages or an injunction against the violation. It does not matter if the relationship is a cooperative arrangement, like the Best Western Hotel system, or a non-profit, like the councils of the Girl Scouts of America, the franchise laws and regulations may apply.
Example

In Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the United States of America, the 7th Circuit decided that the Wisconsin Fair Dealership Law prohibited constructive termination of the Council’s agreement by the proposed re-distribution of its territory.
Example

In To-Am Equip. Co., Inc. v. Mitsubishi Caterpillar Forklift America, Inc., a jury awarded $1.525 million in damages from the wrongful termination of a distributorship agreement. The 7th Circuit affirmed the award under the Illinois Franchise Disclosure Act, stating:
To-Am:

“Like many manufacturers, MCFA simply did not appreciate how vigorously Illinois law protects "franchisees." This does not mean that terminations are impossible, but it does mean that they usually must be the subject of negotiation unless the manufacturer is able to show "good cause." MCFA has conceded that it cannot meet that standard, and it did not litigate the case under that theory. We have considered its remaining arguments and find nothing that requires reversal. While we understand MCFA's concern that dealerships in Illinois are too easily categorized as statutory franchisees, that is a concern appropriately raised to either the Illinois legislature or Illinois Attorney General, not to this court.”
Can a commercial arrangement be both a franchise and an employment relationship ... and so what?
The Answer is Yes!

- And that means trouble
Misclassification of Employees as Franchisees

- Awuah v. Coverall N. Am. Inc., -Mass Supreme Court holds that the contractual franchise relationship was really an employment relationship covered by the Mass Wage Act and did not permit withholding payment of wages until funds were collected from customers and no setoff for franchise fees. In addition, Coverall’s attempt to have franchisees pay for worker’s compensation insurance premiums was similarly impermissible.
Misclassification of Employees as Franchisees (cont.)

- The three prong test in Massachusetts is whether
  1) the worker is free from control and direction in performance of service;
  2) the service is performed outside of usual course of employer
  3) Worker is customarily engaged in an independent business of the same nature as the work performed.

- See also Cano v. DPNY, Inc., No. 10-cv-07100 (S.D.N.Y.) 60 plaintiffs permitted to add Domino’s as a defendant in a labor law case alleging Domino’s could be liable as a joint employer under the Fair Labor Standards Act.
BUT SEE

- **Juarez v. Jani-King of California, Inc., 2012 WL177564 (N.D. Cal. Jan 23, 2012)** holding that a janitorial and cleaning maintenance franchisee was not covered under the California labor laws which would have entitled them to additional wage and job benefits. (Note latest litigation against McDonald’s Corporation)

- **Jan-Pro Franchising Int’l v. Depiants, 712 S.E. 2d 648 (Ga. Ct. App. June 23, 2011)** held no joint employment. Didn’t meet three prong test as franchisor’s business of supporting franchisees was not the service business of a franchisee, which is cleaning.
Worker’s Compensation

Supreme Court of Kentucky reversed its Court of Appeals holding that the franchisor of the Subway system, Doctors Associates, Inc., was liable for the workmen’s compensation claims arising from an uninsured franchisee.
Roadmap for complying with franchise sales laws
U.S. Laws Regulating Franchises and Bus/Ops

- Franchise Sales Laws (‘front end” laws)
  - Federal – Amended FTC Rule: presale disclosure, but no federal filing
  - State – Registration + disclosure duties

- Business Opportunity Laws (‘front end” laws)
  - Federal – exemption for franchises that comply with Amended FTC Rule
  - State – presale disclosure + registration/review
    - There are more states with Bus/Op laws than franchise

- Franchise Relationship Laws (“back end” laws)
  - Good cause for termination, cancellation or non-renewal
  - A handful forbid substantial changes to distribution arrangement
State “Relationship Laws”

- GC for termination + payment of a required fee besides cost of product ("3 prong states")
- GC for termination, but no required fee ("2 prong states")

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Which Law Applies Matters

- Federal law applies to all franchise sales in US.
  - No private right of action
  - Plaintiffs use state “baby FTC Acts” as predicate
- State law jurisdiction varies according to:
  - Assigned territory
  - Licensee’s residence/domicile
- Some state laws require “place of business” in state
- Federal and state laws differ on tests for jurisdiction, exemptions, exclusions = little uniformity
  - Large franchisee (>$/5M net worth)
  - Large transaction (invest >$/1M to launch)
  - Fractional franchise (<20% total revenue/brand)
Key Points About Franchise Sales Laws

- Amended FTC Rule applies to all franchise sales in U.S. even if franchisor, franchisee and franchised business are all in the same state
  - Pre-sale disclosure via uniform FDD
    - 14 day “waiting period”
  - FDD = FYE updates due w/in 120 days after each FYE
  - Material change amendments = quarterly
  - Record keeping duties
    - Each materially different version of FDD – 3 years
    - Each FDD Receipt – 3 years
  - No financial performance representations (“FPRs”) without complying with FDD Item 19 disclosure rules

- No federal preemption; state franchise laws still apply
Key Points About Franchise Sales Laws

- No preemption of state laws/registration duties
- Among “registration states” little uniformity as to definitions, exclusions and exemptions from registration
  - All accept FDD, but may require additional disclosures
- Different levels of review (full; lodging; notice)
  - A handful of states have their own FDD delivery rules
  - Annual permit; renewal registration
  - Material changes; register “promptly” (30 days)
- “Franchise sellers” (employees & 3P brokers)
- Must register advertising of franchise opportunity (not consumer ads)
- Record keeping duties (vary by state)
Complying With Franchise Sales Laws Matters

- Federal and state franchise sales laws = strict liability
  - Consumer protection statutes
  - Franchisee’s sophistication = irrelevant
  - Franchisee’s representation by legal counsel = irrelevant
- State laws = private right of action (damages, rescission, maybe attorneys fees, injunction)
- Joint and several personal liability of the franchisor’s officers, directors and members of key management
  - Franchisor’s entity status = irrelevant since liability is imposed by statute, equivalent to US securities laws
  - Plaintiff’s sue individuals for settlement leverage
Complying With Franchise Sales Laws Matters

- Felony (though criminal liability = rare)
- Federal and state franchise regulatory agencies have broad enforcement authority including to impose cease & desist orders, freeze bank accounts, order restitution, impose fines, etc.
Roadmap for complying with franchise and dealer protection laws
Most “Accidental” Franchises are Discovered in the Context of Termination of a Contract

- Most license agreements and product distribution contracts permit the licensor/supplier to terminate the contract on X days notice for any reason.
- In licensing/dealer/distributor arrangements, the “F” issue is most commonly raised after a licensor/supplier terminates or threatens to terminate arrangement without GC.
  - Licensor/supplier’s conduct that complies with terms of contract is no defense to statutory claim.
  - The fact the contract allows the licensee/dealer/distributor the same right to terminate on X days’ notice without GC is no defense to statutory claim.
Key Points About Relationship Laws

- No federal franchise relationship law
- State franchise relationship laws
  - “3-prong” -
  - “2-prong” -
- Dealer termination laws
  - “2-prong” -
- Special industry laws (alcohol, auto, farm equipment)
  - No special industry laws apply to energy drink segment
The Key to Dealing with Termination Cases

- The key is to comply with the franchise law without conceding that the franchise law applies.
- Typical conditions of franchise termination laws are:
  - Venue
  - Good cause requirements-statutory and case law
  - Choice of law
  - Timing for notices
  - Mandatory purchases of inventory
Venue

- Many states grant franchisees the access to their local courts to address franchise disputes.

Considerations

- Arbitration clauses may defeat the local venue.
- Litigation in the foreign jurisdiction may highlight the conflict of laws.
- Termination decision must be compatible with host forum.
Good Cause

Considerations

- Where a state requires good cause by statute, you must prove good cause exists.
- Good cause may also be imposed by court decision.
- Good cause may not be based on the franchisor’s reasons but only on the franchisee’s material breaches.
Choice of Law

Considerations

- Can the state franchise law be waived?
- Eliminate true conflicts of laws by accepting compliance with the most restrictive law
- Will the choice of forum help decide what law applies?
Timing of Notices

Considerations

- Some states require 30, 60, 90 or 180 day notices
- Articulate the reason for the time, other than compliance with the statute.
Mandatory Purchase of Inventory

- Be aware of states that require mandatory purchases of inventory or sunk investments.
- Offer compensation with the notice to ameliorate the consequences of termination or non-renewal.
- Is it best to characterize the event as a purchase?
Common issues and stress points in franchise relationships
Common issues and stress points

- Vicarious liability
  - Is the franchisor liable to third parties for the franchisee’s act/omissions?
  - Is the franchisor liable to third parties for the franchisee’s employee’s act/omissions?

- Implementing system-wide changes
  - Long term contracts vs. remaining competitive

- Enforcing post-termination covenants not to compete
  - Policing against “break-aways”

- Enforcing system standards
  - Dangers of being joined at the hip; weakest link
Vicarious Liability

- Vicarious liability is imposed on a non-actor that has sufficient control over the actor causing harm to a third party such that society holds the non-actor liable for the actor’s harm.

- Franchisors are sometimes found vicariously liable for acts of their franchisees.

- Greatest challenge to franchising today.
  - VL cases are citing the franchise operations manual – a common feature in most every franchise network and long understood as laying out rules to protect the brand – as evidence of the franchisor’s control.
  - Confusion over “brand-justified” licensing controls vs. control
Vicarious Liability

- A hidden franchisor is likely to be found vicariously liable for acts of the unintended franchisee.
- The reason for the increased risk is:
  - The appearance that the putative franchisor is attempting to mischaracterize the relationship
  - The lack of clear limits on the controls over the licensee.
Typical vicarious liability claims arise either in the franchisee/licensee’s employment context or a third party tort claim:

- Employee of a Domino’s Pizza franchisee claims he was assaulted and sexually harassed by an employee of the franchisee. Domino’s asserted control occasionally over suggested hiring and firing of employees. Held: Possible vicarious liability.

- Hotel franchisor provided plans for automobile path around the hotel, which allegedly contained blind spots and caused auto to collide with pedestrian. Held: Possible vicarious liability. Franchisor mandated use of plan.
Q&A

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