

Franchising: An Updated Look at the Basics

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In the United States, sales of franchises are regulated by the Federal Trade Commission (FTC) and various state statutes and regulations. This practice note will review what a franchise is, the importance of trademark registration for franchisors, and advise counsel on how to avoid a standard license agreement being construed as a franchise agreement. This practice note will also review the applicable state and federal laws and regulations governing the sale/post-sale of franchises and distributorships, as well as related laws covering issues such as termination, renewal, and assignment rights. Last, this practice note will review joint employment liability in the franchise context and discuss how franchisors can minimize their joint employment liability risks.

For additional information, see [Franchisees and Prospective Franchisees Considerations](#), and [Franchise Relationships](#).

Identifying a Franchise

It is difficult to define succinctly what constitutes a franchise, but under the FTC's Amended Franchise Rule (the FTC Rule) and most of the state registration laws, there are three key elements to a franchise:

1. The franchisor and franchisee are mutually associated with a common trademark, logo, or trade name
2. The franchisor must promise to give the franchisee significant assistance or the franchisor must impose significant controls over the franchisee –and–
3. The franchisee is required to pay a franchise fee

See 16 C.F.R. § 436.1. As discussed further below, a “franchise fee” need not be labeled or defined as such in the agreement. Courts have broadly construed a variety of payments from the franchisee to the franchisor or its affiliates to qualify as a franchise fee for the purposes of determining whether a franchise relationship exists. Counsel should therefore carefully review the nature of the payment, rather than how it may be characterized, to ascertain whether the payment will likely be deemed a franchise fee under the applicable law relevant to the client's transaction.

Substantively, state registration laws describe the definitional aspects of franchises in a similar manner, although the wording may appear quite different. Rather than talking in terms of “significant assistance” or “significant control,” most state statutes require that the franchisee be required to follow a prescribed or suggested marketing plan, or that a continuity of interest exist between the franchisee and the franchisor. In essence,

the definitional differences between the FTC Rule and state statutes or regulations are usually not that significant, although certain exceptions exist.

For example, New York's definition of a franchise departs significantly from the FTC's definition. Namely, New York does not require a franchisor to have a "significant degree of control" over the franchisee's method of operation for a franchise to be created. Rather, a franchise relationship is technically formed where the franchisee is granted the right to sell goods substantially associated with the franchisor's trademarks or other symbols that designate the franchisor—in other words, a simple trademark license. N.Y. Gen. Bus. Law § 681. Conversely, a franchise cannot be created under the FTC definition without the franchisor exercising a significant degree of control over the franchisee. In general, the FTC rule preempts state laws only when they provide less protection to franchisees. Consequently, when a franchisor is offering to sell franchises in a state that mandates franchise registration, the franchisor will need to follow both the FTC and state laws governing the sale and operation of the franchise in that state.

The Importance of Trademark Registration to a Franchisor

Obtaining a registered trademark is critical for franchisors. While registration is not required to obtain common law rights in a trademark, the owner of a common law trademark only has exclusive rights to use the trademark in the area of use and the likely zone of expansion. This means that another business, even the same type of business, can use the mark without infringing as long as it is in a separate geographic area. Commerce on the Internet has blurred the definition of what it means to use a trademark in a certain area, which could make it difficult to determine who has the rights to the mark and where those rights apply. To prevent problems like this from arising, franchisors should speak to counsel about clearing their marks for use by ensuring that the mark is legally protectable, available, and does not infringe on someone else's mark. Franchisors should seek to register their trademarks. For additional guidance on this topic, see [Conveying Assets to the Joint Venture – Intellectual Property Licensing Agreements](#) and [Online Trademark and Copyright Enforcement](#).

Federal trademark registration on the Principal Register, which is maintained by the U.S. Patent and Trademark Office (USPTO), entitles the owner of a mark to numerous

benefits that help protect the mark, including a presumption of validity, ownership, and exclusive nationwide use of the mark in connection with the type of goods or services for which it was registered. See 15 U.S.C. § 1057(b). Owners of a federal registration may also use the Lanham Act to pursue trademark infringement claims in federal court. The Lanham Act provides for statutory remedies that would be otherwise unavailable to trademark owners, including damages for infringement that are separate from what the franchisor may be able to claim against a rogue franchisee for breach of the franchise agreement. See 15 U.S.C. § 1114. Another benefit of federal registration is that it serves as constructive notice of the right holder's claim of ownership. See 15 U.S.C. § 1072. After a mark is registered for at least five years, the owner of the mark can seek incontestable status. See 15 U.S.C. § 1065. Incontestable status prevents the mark from being challenged on certain grounds related to it being merely descriptive. If a franchisor does not have a registered trademark, it must disclose the absence of such a registration and the risks associated therewith in Item 13 of its Franchise Disclosure Document (discussed further in Franchise Disclosures below).

Differences between a Franchise Relationship and a Trademark License

A typical trademark licensing arrangement often satisfies most of the elements of the definition of a franchise. In such agreements, the trademark requirement is easily met, there is certainly some sort of license fee charged for use of the mark, and some controls are placed upon use of the mark. In fact, the Lanham Act virtually mandates that some control be imposed upon a licensee in order for the mark to remain valid and the licensor to retain ownership of the mark. The FTC and state officials have stated that these trademark controls alone are not enough in themselves to create a franchise relationship, although counsel should note a strict reading of the language of some state statutes suggests the opposite conclusion.

The difference between a trademark licensing relationship and a franchise relationship often turns on the amount of significant assistance or control that a franchisor exerts over a franchisee. Generally, the more assistance or control that a licensor exerts over its licensee, the more likely a relationship may be considered a franchise, but the lines of demarcation are quite gray.

Determining whether a licensing relationship is a franchise relationship requires a fact-specific analysis of each contractual obligation of a proposed relationship. Counsel should note that significant types of control include:

1. Providing site approval or site selection for unestablished businesses
2. Implementing site design or appearance requirements
3. Controlling hours of operation
4. Mandating production techniques
5. Mandating accounting practices or personnel selection or policies
6. Requiring franchisee participation or financial contribution to promotional campaigns –and–
7. Restricting customers, locale, or area of operation

Significant types of assistance include:

1. Providing formal sales, repair, or business training programs
2. Establishing accounting systems
3. Furnishing management, marketing, or personnel advice
4. Furnishing system-wide networks and website –and–
5. Furnishing a detailed operating manual

See [Fed. Trade Comm'n, Franchise Rule Compliance Guide 2–4 \(2008\)](#).

Generally, the following items do not constitute significant control or assistance:

1. Implementing trademark controls designed solely to protect the trademark owner's legal ownership rights in the mark under state or federal trademark laws (such as display of the mark or right of inspection)
2. Furnishing a distributor with point-of-sale advertising displays, sales kits, product samples, and other promotional materials intended to help the distributor in making sales
3. Providing advertising in various media
4. Implementing health or safety restrictions required by federal or state law or regulations –and–
5. Assisting distributors in obtaining financing to be able to transact business. *Id.*

Avoiding the “Surprise Franchise”

The broad nature of franchise legislation can mean that other business relationships, such as license agreements, could technically meet the requirements for regulation under franchise laws. Distribution arrangements are also often subject to state franchise registration laws and the FTC Rule. While the trademark and control requirements are not usually the definitional aspects that create legal issues for distribution arrangements, the fee element can create controversy as to whether a distributorship will

be classified as a franchise. Usually a distributor, unlike the classical franchisee, pays nothing up front to obtain his distribution rights, and the revenues from which the manufacturer will make his profit come solely from product markups.

Both the FTC and all of the registration states have interpreted the term franchise fee broadly to include almost all revenue received by the franchisor or its affiliates from the franchisee, whatever the source. However, the term franchise fee has also been interpreted to exclude revenues derived from the sale of reasonable amounts of inventory in the ordinary course of business at bona fide wholesale prices. Thus, the traditional distributor who simply buys inventory from the manufacturer will not be deemed a franchisee. On the other hand, if the distributor is required to pay an up-front fee, purchase excessive amounts of inventory, pay inflated prices for inventory, or purchase other items or services from the manufacturer or its affiliates, such as repair equipment or training, all of the federal and state regulatory burdens may apply. Therefore, counsel with clients engaged in distributorship relationships should advise the client as to what activities might cause the relationship to be deemed a franchise, and ensure that the client does not engage in any conduct that might result in an unwanted franchise relationship.

In some jurisdictions, the doctrine of equity could provide a defense to claims of failure to register or comply with franchise disclosure requirements. The requirements for equitable estoppel vary by jurisdiction, but most require (1) promises, (2) reliance on those promises, and (3) harm if the party that made those promises could assert a claim inconsistent with them. Counsel should review local rules to determine whether this defense is applicable in your jurisdiction.

In a case where a trademark license agreement looked like a franchise agreement, the court held that the plaintiffs could not claim that the defendant violated franchise law because the plaintiffs contributed to the drafting of the license agreement, expressly agreed that it was not a franchise, and engaged in conduct that was consistent with the arrangement not being a franchise. *U-Bake Rochester, LLC v. Todd Utech*, 2014 U.S. Dist. LEXIS 7106 (D. Minn. 2014).

Offers of “Business Opportunities” May Be Subject to Regulation

Even if a relationship does not meet the definition of a franchise, it could be considered a business opportunity. See 16 C.F.R. § 437.1 et seq. A business opportunity is a continuing commercial relationship in which the seller

arranges for the purchaser to obtain a supply of goods, commodities, or services, and secures for the purchaser retail outlets or accounts for the goods, commodities, or services, or secures for the purchaser locations or sites for vending machines, rack displays, or any other product sales displays used in the offer or distribution of goods, commodities, or services. Business opportunities are regulated by federal laws. See 16 C.F.R. § 437.1 et seq.

Twenty-five states also have laws covering the sale of business opportunities, which are defined differently under each state statute. See Beata Krakus, Alexander Tuneski, [Caught in the Web of Federal & State Business Opportunity Laws: Managing & Avoiding the Entanglement of Regulations](#), 36th Annual ABA Forum on Franchising, 10 (2013). The state law definitions are often expansive enough to include traditional franchises or distributorships, as well as vending machines and rack displays. Accordingly, these statutes must be taken into account when setting up any franchise or distributorship arrangement. For further guidance, see [State Websites for Franchises and Business Opportunities](#).

Franchise Sales Laws

Regulation of Franchise Sales

Franchise sales are regulated at both the state and federal level. During the late 1960s, instances abounded in which franchisees, expecting to become part of valuable and well-respected chains, made considerable investments in business ventures only to find later that the rights they were granted were worthless and the costs involved in the purchase and operation of the franchise were considerably greater than anticipated. In many situations, representations of expected gross or net income had been vastly exaggerated as well.

As a result, beginning in 1970, states took action to attempt to regulate the industry. Today, 15 states have franchise laws requiring presale disclosures, including California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Of those states, only Oregon does not also have laws requiring franchise registration, and Michigan and Oregon do not require a filing of the presale disclosures. Although each state registration law has its own peculiarities, the statutes are for the most part similar, and all:

1. Contain definitions of the term franchise
2. Require franchises to register with designated state officials before being offered for sale

3. Require certain disclosures be made to prospective franchisees –and–
4. Require a cooling-off period before the franchise offer may be accepted by a prospective franchisee

Each statute provides for civil and criminal remedies in the event a franchisor violates the statute. The civil remedies may be enforced either by designated state officials or by the affected franchisee.

In 1979, the FTC, pursuant to Section 5 of the Federal Trade Commission Act, enacted its [“Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures”](#) (Franchise Rule). In 2007, the FTC approved amendments to the Franchise Rule. The amended FTC Rule has many similarities with state franchise registration statutes and requires certain disclosures be made to prospective franchisees and a cooling off period before the franchise can actually be sold. However, two notable differences exist: (1) there is no registration requirement under the FTC Rule and (2) there is no private right of action if the FTC Rule is violated. Only the FTC can bring civil or criminal actions if a franchisor fails to comply with the FTC Rule.

How Does the FTC Rule Coexist with State Franchise Registration Statutes?

In states without franchise sales statutes, such as Georgia and North Carolina, franchisors must comply with the FTC Rule when selling franchises. In jurisdictions having registration statutes, such as New York, franchisors must adhere to both the state statute and the FTC Rule before franchise sales can be commenced.

The FTC alleviated much of the complexity caused by dual levels of regulation by stating that its rule preempted state laws only to the extent that state laws provided less protection to prospective franchisees. Since most of the registration statutes afford greater protection to prospective franchisees, many of the problems created by dual federal and state regulation were eliminated.

States have also done their part to attempt to make most of their regulations more consistent with the requirements imposed by the Franchise Rule, and this consistency generally carries over to the amended FTC Rule. Counsel should still note, however, that many states have retained their own idiosyncrasies that impose additional or different requirements on franchisors.

Exemptions and Exclusions from the Requirements of the FTC Rule and/or State Statutes

Both the FTC and the states have exempted or excluded certain activities or persons from the scope of regulation. The FTC Rule, for example, excludes certain types of relationships because they do not satisfy the three elements required to be a franchise. These include (1) single trademark and exclusive manufacturing agreements, (2) general partner relationships, (3) employer-employee relationships, (4) cooperative associations, and (5) certification or testing services arrangements. 72 Fed. Reg. 15444, 15529–30.

The FTC Rule also provides for:

1. A large franchisee exemption (franchisee or an affiliate is an entity that has been in business for at least five years and has a net worth of at least \$5,715,500)
2. A large franchise investment exemption (where at least one individual contributes a minimum of \$1,143,100)
3. An exemption for franchise sales to insiders
4. An exemption for department store leasing arrangements
5. A fractional franchise exemption for franchisees that have more than two years of experience in that line of business, and sales from the new franchise line of business make up less than 20% of the business's overall sales
6. A minimum payment exemption where the required payment to the franchisor is less than \$570 within the first six months
7. An exemption for oral agreements for which there is no written evidence of a material term of the franchise relationship –and–
8. An exemption for petroleum marketers and resellers covered by the Petroleum Marketing Practices Act (PMPA)

The exemptions based on a monetary threshold are adjusted every fourth year based on the Consumer Price Index for all urban consumers [CPI-U] published by the Department of Labor and were last adjusted in 2016. State laws, depending upon the jurisdiction, may exempt or exclude large franchisors or large franchisees, isolated sales, or sales by established franchisors. A franchise sale may be exempt from disclosure requirements at the state level, but not at the federal level, and vice versa.

Franchise Disclosures

Required Disclosures to a Prospective Franchisee

If a relationship meets the applicable state or federal definition of a franchise, the franchisor or its counsel must prepare a document known as a “Franchise Disclosure Document” (FDD). The FDD includes certain disclosures mandated by the FTC Rule and state statutes. While the form of the FDD is very similar among the various states, counsel should note that each state has its own peculiarities and the document used to sell franchises in each registration state may be different in certain respects from that used in other jurisdictions. Typically, these state peculiarities are addressed in the form of addenda to the FDD and to related agreements so that a single FDD may be used in all 50 states.

An FDD includes 23 sections called Items, and numerous exhibits. The body of a typical FDD can range from 30 to 50 pages. The entire FDD, including exhibits, often will be over 200 pages. Information relating to the franchise that must be disclosed in the FDD includes, among other things:

- Background information on the franchisor and its key management, officers, and directors
- The amount of initial and subsequent franchise fees to be paid to the franchisor and its affiliates; estimated initial investment costs covering pre-opening and a reasonable start-up period
- Any requirements that the franchisee must purchase certain items from the franchisor or its affiliates or otherwise do business with designated suppliers and/or in accordance with franchisor's specifications –and–
- A summary of certain material provisions of the franchise agreement (such as the term, renewal rights, restrictions on in-term and post-term competition, and territorial rights granted to the franchisee)

Any agreements that are relevant to the franchise opportunity, such as the franchise agreement, must be included as exhibits to the FDD. Audited financial statements of the franchisor must also be included in the FDD, although the FTC Rule allows a phase-in period where a start-up franchisor does not need to include audited financial statements. 16 C.F.R. § 436.5(u)(2). For a sample FDD, see [Franchise Disclosure Document](#). However, counsel should note that certain registration states impose more stringent requirements during the phase-in period which may require a franchisor to obtain audited financial statements.

Claims About a Franchisee's Potential Earnings

A franchisor may make claims about a franchisee's potential earnings if the information is included in Item 19 of the FDD. Item 19 includes financial performance representations that a franchisor wishes to make about its franchise opportunity. A franchisor is not required to include any financial performance representations in its FDD, although majority of franchisors do so.

However, with limited exceptions, a franchisor and its sales representatives may not make any other representations to a prospective franchisee about the earnings of other franchisees, projected earnings of franchises, or sales information, unless the representations are included in Item 19. Thus, if a franchisor does not include financial data in its FDD, the franchisor is unable to answer questions regarding a franchisee's potential income or earnings.

Financial performance representations included in Item 19 may be projections or based on historical results of existing outlets. In practice, the overwhelming majority of financial performance representations present data from existing outlets rather than projections. Data from subsets of outlets may be used if appropriate disclosures are included that allow the franchisee to understand how representative the subset may be compared to the rest of the outlets in the system. There must be a reasonable basis for all claims made in Item 19 and a franchisor must be able to produce the data that was used to make the representations and to substantiate the claims made.

Guidance for Item 19 Financial Performance Representations

The NASAA Franchise Commentary on Financial Performance Representations (FPR) (Commentary) went into effect in 2018. Three provisions from the prior NASAA commentary have carried over into the new Commentary. First, the Commentary clarifies that a franchisor must comply with the requirements of Item 19 if it provides a prospective franchisee with anticipated cost information as a percentage of revenue. However, a franchisor may provide a prospective franchisee cost and expense information in other ways, as long as it is not provided as a percentage of a stated level of revenue. Providing cost and expense information without describing it as a percentage of revenue means that the information will not constitute a financial performance representation within the scope of Item 19. Second, a franchisor cannot attach or include a blank pro forma that only identifies categories of revenue and costs without any corresponding figures to the FDD. Such a disclosure will not constitute a valid financial

performance representation, and should not be included in the FDD. Third, the Commentary includes the warnings a franchisor must give a franchisee and information about how the franchisee's results might differ from the results set forth in the financial performance representation. The Commentary provides language that should be used for historical financial performance representations and projections and forbids franchisors from including additional disclaimers about the financial performance representation.

The Commentary further requires that franchisors disclose how they are calculating their net profit or gross sales if they make disclosures about either number within their Item 19. In addition, franchisors must clearly indicate the source of their data (company-owned and/or franchised outlets), any adjustments made to the data, and why the adjustments were made. A franchisor may not disclose the gross sales of company-owned outlets without also including data from operational franchised outlets, unless it does not have operational franchisees and it has a rational basis for making the disclosure of company-owned outlets. Even if the franchisor has operational franchisees, a franchisor may use data from company-owned outlets when making a gross or net profit financial performance representation. In order to do this, the franchisor must include gross sales data from operational outlets, actual costs incurred by company-owned outlets, and supplemental disclosures or adjustments to reflect the reasonably expected and actual material financial and operational differences between company-owned outlets and operational franchise outlets. If a franchisor is disclosing an average, it must also disclose the outliers and median of that data set.

A franchisor may use only a subset of outlets in its disclosure "if the FPR based on the subset (a) has a reasonable basis, (b) is accurate, and (c) is not misleading." 2017 NASAA FPR Commentary, Section 19.12. For example, if the FPR is misleading to the franchisee, a franchisor cannot make an FPR based on a subset of outlets even if it has a reasonable basis for the FPR and the FPR is accurate. In order to use data from subsets of outlets, a franchisor must not have fewer than 10 substantially similar outlets. Further, if a franchisor discloses a subset consisting of its best performing outlets, it must also provide data from a corresponding subset of its worst performing outlets. In addition to the requirement that projections must have a reasonable basis, the new commentary forbids franchisors from adjusting historical data to make hypothetical claims or using data that is not solely the historical data of the franchise being offered.

When Must a Franchisor Provide a FDD to a Prospective Franchisee?

Under the FTC Rule, a franchisor must provide its FDD to a prospective franchisee at least 14 calendar days before entering into any binding agreement with or receiving any payment from the franchisee. State rules may differ. For example, in New York and Michigan, the FDD must be provided at the earlier of the first personal meeting with the franchisee or 10 business days before the franchisee signs a binding agreement with, or makes a payment to, the franchisor.

Franchise Registration

The Franchise Registration Process

As stated above, there is no federal registration of franchise offerings. However, California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin require registration of franchise offerings. In the 14 states that require registration of franchise offerings, registration can be a difficult and often lengthy task that requires advanced planning by the franchisor and its legal counsel. The franchisor or its counsel must submit the FDD and various other forms to the appropriate state officials, typically the state's Department of Corporations or Attorney General's office. The entire package is referred to as the registration application. Registration applications must be accompanied by the applicable registration fee, which ranges from \$250 to \$750. Registrations are effective for one year and generally must be renewed before their expiration date. Renewal fees are usually approximately one-half of the initial registration fee.

Except in Indiana, Michigan, South Dakota, and Wisconsin (where the formal review process has been eliminated), the state officials are given a period of time—usually about 30 calendar days—to review the registration application and furnish comments to the franchisor. The franchisor must then respond to these comments, either by making the suggested changes, or by convincing the officials that their concerns are unwarranted and that no changes are necessary. While deficiencies can often be corrected with only one revision, it is not unusual for a franchise registration application to be revised two or more times before the state will register the offering and for the entire registration process to take two to three months from the date the registration application is first submitted for review. When the registration process is successfully completed, an order declaring the registration effective

is issued by the state. The order does not indicate that the registration has been endorsed by the state, and any representation to that effect can be a criminal offense.

States Apply Different Standards of Review

The review process by each state has traditionally been independently conducted. Because of other variations in state regulations, the different training programs given to franchise registration examiners, and in some cases the different philosophies of state officials toward the review process, the registration process can take different turns in each jurisdiction, thereby increasing the likelihood that the offering documents will be different in each state. In several jurisdictions, for example, the state officials may simply compare the submitted documents to their state statutes and regulations, and their comments will only reflect variations between the two. In other states, the examiners will give the FDD closer scrutiny and, in some cases, make comments about the merits of the offering itself. Oftentimes, changes requested by one state will result in a franchisor filing amendments in other states so that it can offer a single FDD in all states rather than having a handful of state-specific versions.

There are other differences among states in the registration process. All states can require that initial franchise fees be subject to “financial assurances” which essentially require the escrow, impound or deferral of the initial franchise fee until the prospective franchisee's business opens and/or the franchisor has completed its pre-opening obligations. States also give franchisees the option of providing financial assurance by purchasing a surety bond. However, not all states will require financial assurances and, even in identical factual settings. In many registration jurisdictions, franchise sales literature must be cleared by the state in advance. Again, different standards of review may be applied. The bottom line is that the offering documents and the registration process can vary considerably from state to state, making franchise-selling a cumbersome and expensive process.

For links to official state websites, see [State Websites for Franchises and Business Opportunities](#).

Noncompliance

Penalties for Noncompliance under the FTC Rule

Failure to comply with the FTC Rule can have severe results. For violations of the FTC Rule, the penalty per violation is currently \$140,000. Other remedies include

equitable remedies, assessment of damages incurred by the public, and criminal sanctions.

In practice, the FTC has been viewed as somewhat of a toothless tiger. Because of budget limitations and other factors, the FTC has not taken a very aggressive role in prosecuting FTC Rule violations. As a general rule, the FTC seriously investigates situations only when the franchisor has not provided a disclosure statement or has made financial performance representations in an unlawful manner, when the FTC Rule has been flouted flagrantly, or when widespread harm has been inflicted on the public. Isolated FTC Rule violations are generally ignored, as are technical violations such as violation of the FTC Rule's waiting period before consummation of the franchise sale. The FTC has been more aggressive in prosecuting business opportunities sellers who do not comply with the FTC Rule.

When the FTC has taken on franchisors, it has been very aggressive in seeking relief. It has imposed pre-judgment freezes on the assets of the franchisor and its principal officers. It has also imposed hefty fines on some FTC Rule violators. As for minor or technical violations, the FTC has addressed this problem by implementing a program under which offenders may agree to participate in a remedial program rather than face prosecution. Under this program, the franchisor's management must participate in programs designed to assure that the franchisor is aware of its responsibilities under the FTC Rule, and the FTC will indirectly monitor the franchisor's sales activities for a limited time, typically three years. All things considered, participation in this program is clearly a far more lenient and less expensive alternative than defending an action brought by the FTC, even when the franchisor is arguably in the right. Further, if a franchisor participates in this program, it is relieved of its requirement to make an FDD disclosure about the alleged violation.

The absence of a right in an aggrieved franchisee to pursue a claim considerably reduces the risks of lawsuits resulting from FTC Rule violations. However, many states have adopted so-called Baby FTC Acts which, in essence, give franchisees causes of action for FTC Rule violations. Franchisees may also have state actions available for fraud or unfair or deceptive practices that violate the FTC Rule.

Penalties for Noncompliance under State Registration Laws

The consequences for violations of state registration laws can also be dire. The remedies generally include civil penalties, including fines, provable damages, and injunctive relief. Criminal penalties, which may include

fines or imprisonment, are also possible. State statutes grant franchisees the right to pursue their remedies by themselves, and in most states, grant franchisees the right to rescind their franchise purchases, even if they have suffered no provable damages. Some states have also adopted remedial programs that are similar to the FTC.

While the possibility of FTC enforcement has not been much of a deterrent, state enforcement is viewed with a higher level of fear by legitimate franchisors. Relatively speaking, most states have comparatively devoted more resources than the FTC to enforcing their acts, especially when the violation is the failure of the franchisor to register. However, when a franchisee claims that the franchisor has misrepresented what is being sold, the state may be more reluctant to bring its enforcement powers to bear, absent compelling evidence verifying the aggrieved franchisee's position. Also, isolated technical violations of state law, if handled properly, generally do not bring about the state's full wrath, absent clearly demonstrable damages resulting from the violation.

Franchise Relationship Statutes

Federal Regulations Regulating Franchise Relationships

The federal government does not regulate franchise relationships generally. There are two exceptions to this statement—federal laws do regulate franchise relationships involving petroleum dealers and automobile dealers. The relationship between retailers and parties at higher levels in the petroleum distribution structure are regulated under the Petroleum Marketing Practices Act (PMPA), 15 U.S.C. § 2801 et seq., which imposes restrictions on the termination, renewal, and transfer of petroleum franchises. The Automobile Dealer Franchise Act, 15 U.S.C. § 1221 et seq., more commonly known as the "Automobile Dealer Day-In-Court Act," governs the manufacturer-dealer relationship in the automotive industry. This statute requires automobile manufacturers to deal in good faith—that is, to refrain from coercing or intimidating, and from threatening to coerce or intimidate. In practice, the Act has had little importance and has produced few judicial decisions.

There are other federal laws—for example, the antitrust laws and the Racketeer Influenced and Corrupt Organizations Act (RICO)—that can affect franchise relationships. However, these statutes are not aimed specifically at the franchise arena, but instead at general commercial practices.

State Laws Regulating Franchise Relationships

In contrast to the federal government, 19 states have regulations governing franchise relationships generally. Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, Virginia, Washington, and Wisconsin. Puerto Rico and the Virgin Islands also have franchise relationship laws. In addition, there are many state statutes regulating franchise relationships in specific industries such as beer, wine, and farm and heavy construction equipment.

Scope of Franchise Relationship Laws

While there has been a considerable effort to standardize, from state to state, regulation of the franchise sales process, there is no well-discerned pattern of state franchise relationship regulations. Aspects of the franchise relationship that may be covered by these statutes include terminations, renewals, transfers, encroachment, freedom of association, and purchasing restrictions, but no two statutes are substantially identical, except Rhode Island's and Wisconsin's. Most of them focus on only one or a few of these areas, and in many instances, the regulatory approach among the states is dramatically different. The result is a very complicated regulatory scheme.

This disparity among the states begins with the fundamental issue of how franchises are defined. Typically, the definition of franchise is similar to the definition under the FTC Rule and includes the same three elements. Virtually all of the statutes provide that the relationship must include the use of a trademark, logo, commercial symbol, or the like, and that the franchisor must charge the franchisee a fee in order for a franchise to exist. It is the third prong of the definition where the statutes diverge. In some states, there must be a "community of interest" between the franchisor and the franchisee; in others, the franchisor must prescribe or suggest to the franchisee a "marketing plan." Not all states—New Jersey and Wisconsin, for example—require all three elements to be present in order for the relationship to be subject to the statute. New Jersey, for example, has no fee requirement.

Regulation of Franchisee Terminations

Most franchise relationship statutes require a franchisor to have good cause before terminating a franchisee. Good cause is usually defined to include the failure of a franchisee to adhere to the provisions of the franchise agreement. In addition, most statutes require the franchisor to give the franchisee notice of a breach or default and an opportunity to cure. This notice requirement is generally not

applicable to certain types of defaults such as bankruptcy, insolvency, or abandonment.

Today, in practice these statutes usually have little effect on the termination process, for it is more common than not for a franchise agreement to contain provisions that substantially parallel the statutory requirements. Thus, even if the termination provisions of the relationship statutes were repealed, practice in the industry would remain largely unaffected. Most franchisors follow these termination procedures in large measure even in states where terminations have remained unregulated. This is probably due to a desire to maintain uniformity in the administration of the franchise system as well as the fact that courts in many jurisdictions have a predilection to prevent forfeitures, absent compelling circumstances, even though freedom of contract is the general rule in the U.S. judicial system.

Regulation of Franchise Renewals under State Laws

In franchising, mandatory renewal rights are typically granted to franchisees. There are, however, some very well-known chains (McDonald's, for example) in which renewals are granted only at the franchisor's discretion. Some franchise relationship statutes are designed to deal with these situations.

In some states, such as Wisconsin, nonrenewals are not permitted absent good cause. See Wis. Stat. § 135.03. This, in effect, may require a franchisor to continue a relationship beyond the bargained-for period. Other states, such as Missouri, simply impose procedural requirements upon the franchisor (e.g., 180 days advance notice of a decision not to renew). A third group of statutes imposes various burdens on the franchisor if it elects not to renew. For example, the franchisor may have to compensate the franchisee under Washington law, and in Iowa, the franchisor must agree not to enforce the post-term noncompetition provision of the franchise agreement.

Regulation of Franchise Transfers under State Laws

Most franchise agreements permit transfers, but vest varying degrees of control in the franchisor over such transactions. The most stringent agreements provide that transfers may only be made with the franchisor's consent, and such consent may be arbitrarily withheld. Other agreements simply state that consent may not be unreasonably withheld. It is also quite common for the franchise agreement to delineate some of the reasons that would permit the franchisor to deny transfers. These

may include financial or technical inability, poor character, or existing interests in competing businesses. It is also common for the franchisor to impose varying conditions upon the transfer. These may include execution of a new form of franchise agreement, payment of a transfer fee (which may be substantial), execution of a general release by the transferor in favor of the franchisor, and completion of requisite training.

Generally, state statutes regulating transfers require the franchisor to have good cause for withholding consent. Some statutes also require the franchisor to approve a transfer if the transferee meets the criteria for new franchisees. Other states have flip-flopped the approach and require the franchisee to notify the franchisor of the proposed transfer and to furnish it with specified types of information; the franchisor is then required to respond to the request within a specified period. Finally, in at least one state—California—the statute protects the rights of a deceased franchisee's heirs to take over the business. See Cal Bus & Prof Code § 20027.

Franchise Statutes Protection of a Franchisee's Freedom of Association

Eleven states have adopted provisions limiting the franchisor's right to intervene in collective conduct by franchisees. Freedom of association statutes tend to take one of two forms. They prohibit a franchisor from either (1) restricting or inhibiting the rights of franchisees to join an association; or (2) prohibiting, directly or indirectly, the right of association among franchisees for any lawful purpose.

Interestingly, there have been few cases to date that discuss any of these statutes. The leading precedent is 30 years old. That decision—*McAlpine v. AAMCO Automatic Transmissions, Inc.*, 461 F. Supp. 1232 (E.D. Mich. 1978)—suggests that freedom of association is a constitutionally protected right of franchisees, which in turn might suggest that state regulation in this area may be unnecessary—a contention to which franchisee advocates would certainly object.

Limitations on a Franchisor's Ability to Encroach on a Franchisee's Territory

From a regulatory standpoint, the states have been notably silent on the encroachment issue where a franchisor has infringed upon his franchisee's arguably exclusive territorial or customer rights. Only four states—Hawaii, Indiana, Minnesota, and Washington—have statutes or regulations prohibiting encroachment. Iowa hampers, but does not prohibit, encroachment. Numerous court

decisions, however, have addressed franchisee claims of encroachment.

Joint Employment Liability

Limiting the risk of joint and vicarious liability is essential for any franchisor. One area of concern for franchisors is joint employment liability. In order for a franchisor to be exposed to joint employment liability, the employee must be legally considered as the employee of the franchisor. Joint employment arises when "employment by one employer is not completely disassociated from employment by the other employer." See *Joint Employment Relationship Under Fair Labor Standards Act of 1938*, 29 C.F.R. § 791.2(a). There are four tests to determine joint-employment: the common law test, the "single employer" test, the National Labor Relations Board's (NLRB) test, and the Department of Labor test. The applicable test depends on what statute a claim arises under, but each test hinges on how much control over the employee is sufficient to be considered an employer.

In order to determine that an employee has joint employers under the common law test, the employee must (1) "render services to at least one of the employers" and (2) "that employer and the other joint employers [must] each control or supervise such rendering of services." Restatement of Employment Law § 1.04(b). The amount of control necessary varies by jurisdiction.

Cases that arise under Title VII of the 1964 Civil Rights Act use the single employer test. Along with the critical factor of which employer made final decisions about the employee, four factors are considered in determining liability: "(1) interrelation of operations, i.e., common offices, common record keeping, shared bank accounts and equipment; (2) common management, common directors and boards; (3) centralized control of labor relations and personnel; and (4) common ownership and financial control." See *Swallows v. Barnes & Noble Book Stores, Inc.*, 128 F.3d 990, 993–94 (6th Cir. 1997).

In 2015, the NLRB created a new, two-part test to determine joint employer liability in *Browning-Ferris Industries of California, Inc. d/b/a BFI Newby Island Recyclery*, 362 NLRB No. 186 (2015). This test focused on if the potential employer had the right to exercise control over employees, rather than if the employer exercised actual and direct control as emphasized under the prior standard. On February 26, 2020, the NLRB published a final rule overturning the *Browning-Ferris* holding and returning to the traditional test to determine joint employer liability. The NLRB's final rule became effective April 27,

2020. To be a joint employer under the NLRB, an employer must “share or codetermine the employees’ essential terms and conditions of employment” by “possess[ing] and exercis[e] . . . substantial direct and immediate control” over one or more of the “essential terms and conditions of employment” of another employer’s employees so that the “entity meaningfully affects matters relating to the employment” of those employees. 29 C.F.R. § 103.40.

Effective March 16, 2020, the DOL published a new standard for determining joint employment liability and recognized two potential joint employer scenarios. For the first scenario, the employee has an employer who employs the employee to work, but another entity benefits from that work. In the second scenario, one employer employs an employee for one set of hours in a workweek while another employer employs the same employee for a separate set of hours in the same workweek. To determine joint employer status for the first scenario, the DOL will look at whether an entity “(i) hires or fires the employee; (ii) supervises and controls the employee’s work schedule or conditions of employment to a substantial degree; (iii) determines the employee’s rate and method of payment; and (iv) maintains the employee’s employment records”. The new rule indicates that an employee’s “economic dependence” on an entity does not impact the joint employment liability analysis, as well as operating as a franchisor, providing sample employee handbooks or forms to an employer, allowing an employer to operate a business on the entity’s premises, offering health or retirement benefits to an employer, and requiring a business partner to conduct background checks or establish minimum wages and numerous workplace policies. To determine joint employer status for the second scenario, if the employers are acting independently of each other and are disassociated with respect to the employment of the employee, each employer may disregard all work performed by the employee for the other employer in determining its liability under the FLSA. 29 C.F.R. § 791.2.

Prior to the passage of the new DOL rule, a number of states had passed their own laws to clarify who is a joint employer and/or what standard to apply to resolve the joint employer liability issue. As a response to the recent passage of this law, 18 states have brought a lawsuit alleging that the DOL’s new rule is arbitrary and capricious: District of Columbia, Colorado, Minnesota, Maryland, Illinois, Washington, New Mexico, Pennsylvania, New York, Vermont, Massachusetts, Rhode Island, Delaware, New Jersey, Oregon, Virginia, California and Michigan. This case has yet to be decided.

Minimizing Joint Employment Liability Risks

In order to minimize joint-employment risks, counsel should ensure that franchisor clients take steps to clearly delineate the roles and responsibilities of the franchisor and franchisee in the operations manual, with the franchisee being responsible for the day-to-day operations. You should also examine if the requirements imposed by the franchisor on the franchisee are necessary.

Franchisors can mandate brand standards, but expose themselves to risk if they mandate the manner and means of complying with those standards. It is a better practice for the franchisors to include recommendations, best practices, or optional guidelines in their operations manual that help the franchisee meet the brand standards. Franchisors could also retain the right to approve the franchisee’s compliance with brand standards, but should be careful to balance the amount of control exercised against the franchisee. Further, the operations manual can suggest particular training standards, but should make clear that franchisees are solely responsible for training employees and that the franchisee alone has the control over its employees. If a franchisor wants to train managerial employees, it should limit the training to a small number of essential employees. If the franchisor is going to communicate with the franchisee or the employees of the franchisee about issues related to employment, the franchisor should provide only nonmandatory guidance and remind the franchisee’s employees that they are not employed by the franchisor. The franchisor’s support staff should be trained in how to interact with franchisees without exposing the franchisor to liability.

Franchisee’s Rights Upon a Franchisor’s Bankruptcy in Mission Product

In general, a bankruptcy debtor can either assume or reject most types of executory contracts. In franchising, that meant that a franchisee’s right to continue to use the franchisor’s marks and other intellectual property could become unclear after a franchisor filed for bankruptcy. A recent case -

Mission Product Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652 (2019) – brought much needed relief to franchisees whose franchisors attempting to reorganize.

The Court held in Mission Product that “a debtor’s choice to reject an executory contract under [the bankruptcy code] functions as a breach of the contract rather than unwinding

the rejected contract as if it never existed.” Therefore, a franchisor’s rejection of a franchise agreement does not automatically cut off the franchisee’s right to continue using the marks and other intellectual property following rejection.

That is good news for franchisees. However, the Court did not go so far as to declare that a licensee can continue using the licensed mark in every instance following a debtor’s rejection. Rather, the inquiry is whether the licensee’s right to continue using the licensed mark would survive under applicable non-bankruptcy law had the licensor breached the trademark license outside of bankruptcy. The answer to that question depends on the terms of the trademark license or franchise agreement and the applicable non-bankruptcy law governing such agreement.

Conclusion

For the company planning to enter into distribution or licensing arrangements in the United States, care must be taken to consider the applicability of federal and state franchise and business opportunities laws and regulations. Compliance is not difficult to achieve, but it requires management of time and financial resources, as well as close association with competent counsel familiar not only with the published statutes and regulations, but with the unwritten “folklore” of franchising, the registration process, and, in some instances, the state administrators themselves. Once a franchise system is up and running, franchisors must be cognizant of state regulations that impair a franchisor’s freedom of contract. Designed to remedy early abuses in franchise relationships, these statutes may result in franchisors being limited in how they deal with franchisees in certain situations, such as terminations, nonrenewals, transfers, and freedom of association. While the regulatory framework can be cumbersome, given that franchising has continued to flourish, it appears that a proper balance has been struck between the needs of franchisees for protection against power-hungry franchisors and the need for franchisors to be able to practice the entrepreneurial skills that have made them successful.

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