

Hidden and Creeping Franchise Fees: Old Lessons Worth Remembering

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Every franchise lawyer knows that one of the conditions for a distribution arrangement to be considered a franchise is that the franchisee is required to pay (whether in cash or other consideration) a "fee" to the franchisor or its affiliate (hereinafter referred to collectively as the "Franchisor"). The term "fee" is broader than it might first appear. Direct fees are easy to spot—usually they are represented by cash payment to the franchisor for the right to obtain access to the franchisor's system and trademarks, and may be up-front payments or ongoing royalty payments.

There are some exceptions to this definition. For example, payments for inventory sold to a franchisee at bona fide wholesale prices are not considered fees. Also, in some jurisdictions, there are exemptions for small payments—typically \$500 or less.

There are also what are known as "indirect" payments of fees, which might include required purchases of services from the franchisor, such as training, or inventory payments where the inventory must be purchased from the franchisor at inflated prices, presumably giving the franchisor a higher than market value return on these sales.

Every true franchise lawyer is also familiar with the concept of the "accidental franchisor," a situation where one party, who is a manufacturer or supplier of goods or services under its marks, meets all the definitional requirements to be a franchisor, including the fee requirement, but unwittingly fails to comply with franchise sales and franchise relationship laws. This can have serious consequences, for that franchisor is subject to both the laws governing the sales of franchises, and the laws governing the relationship between the franchisor and its "franchisees." The consequences of not complying with these laws can be serious. They may include injunctive relief, civil fines, liability to private plaintiffs, and even criminal remedies.

The impetus to this column was a discussion earlier this month on the ABA's Forum on Franchising Listserv. One participant on the Listserv asked whether a particular company was a "franchisor"? As a matter of background, in generic terms, there are, for the most part, three requirements for an arrangement to be classified as a franchise. First, there must be a trademark involved in the relationship. Second, as noted above, there must be a required fee to be paid by the franchisee to the franchisor. Third, there must be a certain level of control asserted by the franchisor over the franchisee, or the franchisor must provide substantial assistance to the franchisee.¹

For purposes of this column, we will assume in the case described on the Listserv that the trademark and control tests have been met. But the participant asked: Has there been a direct or indirect payment made by the company to those persons who are delivering the company's service to the public? The response to this question was overwhelming; in fact, it probably was the most extensive outpouring in the Listserv's long history.

In this situation, a company enlisted a service provider in the transportation industry. The revenues for delivering the services were collected from the customer who paid the company for the services rendered by the service provider, and a portion of this amount was then paid to the service provider. For purposes of this discussion, let's also assume that there were no payments required of the service provider to the company or its affiliates.

Some of the Listserv responders argued that this type of arrangement was no different than one found in the common salesman situation. Others argued that the split between the company and its service providers was so beyond what a salesman normally might receive in the way of commissions that it should not be considered like a commission, but more like something else. In their words, it was an indirect franchise fee, and substance should rule over form. The franchise relationship could just as well be structured with the customer paying the delivery provider, with a portion of the proceeds then being paid to the franchisor.

Overlooked by those taking this position was that the credit risk was being taken by the company in the first scenario, but could be different when the money flows up to the franchisor. At the end of the day, it appeared that the language of the franchise sales and relationship statutes, and existing legal precedents,² indicated that the arrangement was not a franchise because the service provider was not making any payments to the company, and was consequentially not making any type of investment in the system.

'Creeping' Franchise Fee

This lengthy dialogue brought to mind one other situation where payments made to a franchisor were viewed as the payment of a franchisee fee, which I will label as the "creeping" franchise fee. In this situation, the issues were whether there was any "fee" paid at all, and if so, whether the threshold amount under the Illinois Disclosure Act (\$500) had been exceeded. In this case, *To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift America*,³ the arrangement did not commence as having a direct or indirect franchisee fee; thus it did not qualify as being a franchise for franchise sales law purposes at the time an agreement was entered into. But over the course of time, it became a franchise arrangement as a result of required payments made during the existence of the franchise relationship, and therefore, the franchisor became subject to the franchise relationship provisions of the Illinois Act.

To-Am, a now often forgotten precedent, may be unique in its factual situation, but it demonstrates the challenge lawyers face when advising their clients as to whether an arrangement will or will not be subject to franchise sales or relationship laws. Much of a franchisor lawyer's practice may be devoted to counselling a client how not to be a franchisor, and advice on this subject at the time the client establishes its distribution system is critical. But franchise-related advice should not end once the franchise sale has been completed. Unlike franchise sales laws, which are essentially a snapshot in time, the lawyer and his client must always keep in mind the accidental franchisor problem, not only when creating a distribution system, but during the course of its existence. It is, in effect, more like a motion picture than a photograph.

To-Am Facts and Ruling

The facts of *To-Am* showed that during the course of To-Am's relationship with Mitsubishi, it had bought several copies of Mitsubishi's operations manual. One copy came free, but To-Am concluded that it needed a copy not only for its home office, but for each of its mobile units. Without having a manual always present with each mobile unit, To-Am was concerned that its employees would not be able to perform at a service level that measured up to Mitsubishi's quality standards. Thus, while To-Am was not legally required to have more than one copy of the manual, in reality, it needed several, which it bought from time to time as it added mobile units.

By the time Mitsubishi decided to terminate its relationship with To-Am, which was permitted without cause under their agreement, the cost of the purchased manuals exceeded the threshold amount of \$500, and thus a franchise arrangement had sprung up over time. In terminating the relationship, Mitsubishi failed to give the notice required under the Illinois statute, and thus the termination by Mitsubishi was unlawful. This was a terrible mistake by Mitsubishi, for the damages awarded to To-Am exceeded \$1.5 million.

Under Illinois law, the controlling law in this case, there was an exemption for payments that were less than \$500, but unlike the Federal Trade Commission's rule, there was no specification as to when these payments were required in order to be included in this exemption. The FTC minimum payment exemption

covers payments made within the first six months of the establishment of the franchise relationship. The Illinois statute was not so specific, and the court concluded that the \$500 exemption applied to all payments made during the course of the relationship. In *To-Am*, the payments were made over a several-year period.

Nonetheless, the *To-Am* story ends with the Seventh Circuit affirming the trial court's conclusions that (1) the relationship between the parties was a franchise under Illinois law and subject to the relationship provisions of that state's franchise statute; (2) although technically not required payments under the distribution agreement, the payments for the additional manual purchases constituted de facto required payments from To-Am to Mitsubishi; (3) the relationship was unlawfully terminated; and (4) the damage award of the trial court, which was approximately \$1.5 million should be upheld.

Notably, had To-Am simply photocopied its copy of the manual (which might have been a copyright violation if done without Mitsubishi's consent), or if Mitsubishi had just furnished additional copies of the manual to To-Am, without charge, there would have not been a franchise relationship at the time To-Am was terminated and Mitsubishi would have had \$1.5 million more in its corporate coffers.

The lessons to be learned from *To-Am* are two: First, companies must be continuously assessing whether their relationships with their distributors have crossed the line from distributorships to franchises. And second, sometimes it pays to be a little generous when dealing with distributors. Although not expressed in these terms, the old saying, "Pigs get fat; hogs get slaughtered," is the moral of the *To-Am*/Mitsubishi story.

Endnotes:

1. This is a gross simplification of the definitions of a franchise, but will suffice for purposes of this article. The Federal Trade Commission has one definition; the definition of franchise varies among the states that have franchise disclosure laws. And to make matter a little more complex, the definitions of a franchise in the 17 state franchise relationship laws can be different. Also, rather than having a three-prong test, in New York, either trademark presence and a fee requirement OR a control and fee requirement will be sufficient to make an arrangement a franchise.

2. See *Adees Corp. v. Avis Rent-A-Car Sys.*, 2003 U.S. District Lexis 26293 (C.D. Cal. 2003, aff'd, 157 Fed. Appx 2 (9th Cir. 2005) and *Jon K. Morrison v. Avis Rent-A-Car Sys.*, 2003 WL 2311 9903 (W.D. Wash. 2003)

3. Bus. Franchise Guide ¶11, 134, (N.D. Ill. Jan. 24, 1997).

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