New York Franchise Act: Out in Left Field

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Franchising is a relatively new body of law with a complex regulatory scheme. Both the franchise sales process and the relationship between franchisor and franchisee during the term of the franchise are regulated. At the federal level, the Federal Trade Commission (FTC) requires franchisors to make prescribed disclosures to prospective franchisees, and, in addition, some 13 states have similar disclosure requirements and make franchisors register their selling efforts with the state. Fortunately, the state and federal disclosure requirements are very similar, but not exactly the same, leading to some need to have slightly different documents in order to comply with both federal and state disclosure requirements.

On the relationship side, approximately 22 states have adopted statutes of general applicability that govern various aspects of franchise arrangements once the franchise relationship has been established. These may include protection of franchisees from unjust terminations or nonrenewals, limiting the rights of franchisors to disapprove assignments or product sourcing, encroachment restrictions on the franchisor, and protecting franchisees' freedom to associate with other franchisees.

The New York Statute

New York is one of the states that regulates franchise sales, and it was a latecomer to the party. Most franchise statutes in both the sales and relationship arenas were in place by 1975. While a few states subsequently adopted relationship laws, only New York adopted a franchise sales regulation statute after the FTC's Franchise Disclosure Rule went into effect in 1979. The New York statute became effective in 1981. Presumably, many of the other states that did not have franchise sales statutes felt that the FTC's entry on the scene was sufficient.

The New York statute in large measure resembles the sales registration statutes of other states. It requires a franchisor to submit an application to the New York Department of Law before offers or sales of franchises are made from or to New York. The state reviews the application, which will include a disclosure statement very similar to the one required by the FTC, and, if appropriate, the state sends the franchisor comments on its filing and associated documents, pointing out deficiencies and sometimes asking for additional information.

After perhaps one or two back and forths between the state and the applicant—sometimes more—the franchisor's application goes "effective," and the franchisor is authorized to offer or sell franchises in New York for one year, after which a renewal application can be filed. If the state and applicant cannot agree on proposed changes recommended by the state, the franchisor cannot unleash its sales efforts until this stalemate is resolved.

The New York Franchise Act (NYFA), like the statute in the other states, also has an anti-fraud provision, similar to the Securities and Exchange Commission's Rule 10b-5. Remedies for violating the NYFA include damages, rescission, civil fines, revocation of an application, and injunctive relief. There are also provisions for criminal prosecution.

Two Anomalies

However, the NYFA has two anomalies when compared to other franchise sales acts. One is frightening; the other is terrifying.

To illustrate the frightening one, let's compare California's franchise sales law to New York's. A franchisor in California need not register its offering if all of its offers or sales are for franchises to be operated in other states, or its offering is only to persons who are not residents of California. Thus, a franchisor domiciled in Los Angeles does not need to file a franchise registration with the California Corporations Commission unless the franchise sales directly affect the interests of California residents or businesses to be located in California. While it is unlikely that a franchisor with an active sales program will not be making offers in that state, this does happen on occasions, especially in systems that have California-based company-owned units, but want to franchise in other parts of the United States.

New York, however, goes one step further. Franchisors residing in New York must register their franchise offering in New York regardless of where the offers or sales are made or where a unit will be operated. In a recent case, *A Love of Food I v. Maoz Vegetarian USA, Inc.*,[1] the franchisor had its principal office in New York City, and made an offer to a resident of Maryland (a registration state), whose office was located in the District of Columbia. The franchisor was not registered in Maryland or in New York, and thus the franchisee brought suit alleging, among other things, violation of both states' franchise sales statutes. The court concluded that the franchisor's failure to register in New York and Maryland were both viable claims.

The result of this decision, one would think, is that franchisors who plan to make New York their place of business should think twice before incorporating in New York or opening an office there if they are not planning to sell franchises in that jurisdiction, and in fact it is my anecdotal experience that New York does have proportionately fewer franchisors doing business as a franchisor than many other states, including Illinois, Maryland and Virginia (all registration states) and Georgia, Texas and Colorado (all non-registration states). Whether there is a correlation between the NYFA and this observation I do not know. But intuitively, the statute is not a good incentive for encouraging franchisors to domicile themselves in New York.

There is also a second aspect of the problem just discussed. Not only does this apply to domestic situations, it is also applicable to international sales. A New York franchisor who wants to sell a franchise in another country must comply with the registration provisions of the NYFA absent an applicable exemption. In many international situations, the franchisor may be offering and selling individual franchises, but may, in addition or instead, be offering and selling master rights to all or a portion of the country. In these foreign circumstances, much of the information contained in the franchisor's document under the NYFA will be irrelevant or inaccurate. For example, the cost elements provided in item seven will be considerably different for the sale to a franchisee in another country.

The problem described above, however, pales in comparison to the problems created by a second anomaly in the NYFA. Except for New York, all of the state registration statutes require that three elements be present in order for a franchise relationship to exist. In generic terms, they are: (1) the presence of a trademark relationship between the licensor and licensee[2]; (2) money or other consideration being paid by the licensee to the licensor; and (3) the licensor must either provide substantial assistance to, or assert substantial control over, the licensee (such assistance or control also sometimes being characterized as a "marketing plan").

In contrast, for a franchise relationship to exist under the NYFA, only two of these elements must be present: there must be money or other consideration paid by the licensee to the licensor, and either: (1) the presence of a trademark relationship, or (2) the licensor must either provide substantial assistance to, or assert substantial control over, the licensee. To state it baldly, in New York, all trademark license agreements are franchise agreements and many consulting agreements may be franchises as well.

This conclusion comes as a great surprise to numerous brand owners and consultants who are based in New York. For example, a New York perfume manufacturer who licenses its marks is a franchisor, as are clothing, food brands, and footwear licensors, regardless of whether or not they provide any control over their licensees. This is true not only if the license relationship involves the manufacturers' or suppliers' primary products, but also with respect to collateral goods (e.g., a perfume manufacturer's licensing its rights to produce T-shirts bearing the manufacturer's marks). And because of the extraterritorial reach of the NYFA, all trademark licensors who license their marks to New York licensees fall under the NYFA as well.

Similarly, a consulting firm based in New York that charges for its consulting services may be a franchisor because it receives income and it may be providing substantial assistance to its customer, especially where the subject of the arrangement is marketing advice.

Need for Change

There has recently been one attempt to amend the NYFA to bring it into line with other states' franchise sales laws,[3] but so far these efforts have gone nowhere. Starting around two years ago, the New York State Bar Association's Franchise Distribution and Licensing Committee of the Business Law Section examined the problem and submitted to the New York State Attorney General's office, which oversees franchise regulation in New York, amendments to the NYFA that would have cured the problems noted above, but the state has been slow to react, and might even be said to have played ostrich to the problem.

The need to make the proposed change to the definition to the term "franchise" so that there are three prerequisites rather than two, is in this author's opinion, alone sufficient reason to amend the NYFA. There is always the risk, however, that the proposed amendment might end up creating more problems, depending upon how the various stakeholders, including state legislators, respond to any proposed legislation. One would hope that the attorney general and the Legislature would listen to the pleas of the practicing franchise bar, whose members have now had more than 20 years to see how the act plays out in the marketplace.

One of the challenges for proponents of change is that concrete examples of abuse are not abundant. However, the clear risk that claims against putative franchisors asserted against those that one would not think of as being franchisors is very real and will certainly come as a shock to the putative franchisor. One would nevertheless hope that the state would focus on the potential problems in the NYFA at a speed greater than that of Jello.

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Endnotes:

1. Bus. Franchise Guide (CCH) ¶14,684 (D. Md. Sept. 13, 2011).

2. Technically, there need not be an actual trademark license for this condition to be fulfilled. An association between the franchisor and franchisee where the franchisee uses the marks may be sufficient to meet this condition.

3. See Pitegoff, T., "Franchising in New York After the Revised FTC Rule," *NYSBA NY Business Law Journal*, Fall 2007.