

**THE ACCIDENTAL FRANCHISE:
APPLYING FRANCHISE LAWS TO LICENSES AND DISTRIBUTION AGREEMENTS**

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I. INTRODUCTION TO FRANCHISING AND FRANCHISE LAWS

Franchise laws have been applied to contractual relationships that to some appear far removed from the traditional franchise industries, including software licenses, insurance agencies, and dealer agreements.

Franchising as an identifiable form of business began in the 1950's with such chains as McDonald's, Holiday Inn, H & R Block, Century 21, and KFC. Growth accelerated in the late 1970's, and shows no sign of slowing. With the growth of franchising has come government regulation, to curb perceived industry abuses. In the U.S., about 40 states and the Federal Trade Commission ("*FTC*") now regulate franchise offers. Of these 40 states, 12 require registration of the offering circular, 8 require notice filing, and rest either require disclosure, regulate the relationship between franchisor or franchisee, or cover some franchises under business opportunity disclosure and registration laws.

Internationally, about 25 countries also have passed franchise registration, disclosure or relationship laws, including, for example, some major U.S. trading partners: Canada (Ontario and Alberta provincial laws), Mexico, Brazil, China, Korea, Japan, France, Spain, Russia and Australia. Many countries also have laws that apply to the franchise relationship, but the scope of those laws is not limited to franchising. Examples of such laws include: trade regulation laws that limit certain restrictive covenants in franchise and distribution agreements, technology transfer agreement registration laws in many developing countries, and laws restricting termination of agents and distributors that may apply to franchises.

If a relationship is a franchise, franchise laws may regulate pre-offering disclosure, may require registration with and approval by a government agency, and may regulate some terms of the contract and of the relationship. Violations of these laws can result in criminal charges, fines, civil liability with private causes of action, personal liability of responsible employees and owners, damages, rescission (return of investment), voiding of the agreement, attorneys fees, court costs, and punitive or treble damages.

Franchise laws vary in their scope, and may regulate: franchise sales methods and representations, pre-offering registration, pre-sale full disclosure of material facts and anti-fraud rules, limits on the termination or non-renewal of franchises, limits on placement of new franchisees and dealers and other "anti-encroachment" and territory protection rules, limits on franchisor ability to restrict the repurchase or assignment or sale of franchises, limits on franchisor ability to restrict the source of goods or the franchisee's product lines, and many others.

II. DEFINITION OF FRANCHISE

A. FTC Definition.

The definition of what constitutes a franchise under law varies considerably from country to country, and from state to state. The definition that applies throughout the United States by virtue of the Federal Trade Commission Rule ("*FTC Rule*"), 16 C.F.R. 436, is that a franchise is an oral or written agreement (or series of agreements) that contains each of the following three elements:

- (1) Permission, express or implied, to do business under a unified trademark or other commercial symbol;
- (2) Payment to the trademark owner or affiliate, directly or indirectly, in any form, including future payments, such as royalties (excepting only a bona fide wholesale price paid for goods for resale);
- (3) Existence of significant controls or assistance (in some states this is defined as a marketing plan or as an ongoing commercial relationship between the parties).

The parties' written characterizations of the nature of the relationship are not binding. "A rose is still a rose, by any other name."

B. Washington Definition.

The definition of what constitutes a franchise under law varies from state to state. See e.g., Washington Franchise Investment Protection Act ("WFIPA"), RCW 19.100 et seq. In Washington and several other states, a franchise has three essential elements:

- (1) a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed [or suggested] in substantial part by a franchisor; and
- (2) the operation of the franchisee's business . . . is substantially associated with the franchise trademark . . . or other commercial symbol designating the franchisor or its affiliate; and
- (3) the franchisee is required to pay a fee.

Many states have unique variations of this definition. For example, in Virginia only retail goods or retail service franchises are covered. In Wisconsin, Virginia and Washington, the terms "or suggested" are added after the term "prescribed".

Each element must be present for a franchise to be present. Courts will not be bound by the parties' characterization of the relationship. Blanton v. Texaco Refining & Marketing, Inc., 914 F.2d 188 (9th Cir. 1990).

C. Oregon Definition.

Similarly, under the Oregon Franchise Act, ORS 650.005 et seq., the three essential elements of a franchise are:

- (1) a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor;

- (2) the operation of the franchisee's business . . . is substantially associated with the franchisor's trademark . . . or other commercial symbol designating the franchisor of such plan or system; and
- (3) the franchisee is required to give the franchisor a valuable consideration for the right to transact business pursuant to the plan or system.

D. Special Industry-Specific Franchise Statutes.

Some industries are subject to state and federal legislation dealing solely with the specific industry, and may or may not be exempted by these laws from general franchise or business opportunity statutes. Industries with specific franchise or dealer relation laws include:

WASHINGTON STATUTES

- Unfair Motor Vehicle Practices Act, RCW 46.70.18 (1987)
- Beer & Wine Wholesale Distributor Supplier Equity Act, RCW 19.126 (1987)
- Gasoline Dealers Bill of Rights Act, RCW 19.120 (1987)
- Farm Implement, Machinery, Parts, RCW 19.98 (1987)
- Unfair Cigarette Sales Below Cost Act, RCW 19.91 (1987)
- Miscellaneous Regulatory Provisions dealing with Intoxicating Liquor, e.g., RCW 66.28.10, .155, .170

FEDERAL STATUTES

- Automobile Dealer's Day in Court Act, 15 U.S.C. §§ 1221-1225 (1982)
- Petroleum Marketing Practices Act, 15 U.S.C. §§ 2801-2824 (1982)
- Soft Drink Interbrand Competition Act, 15 U.S.C. §§ 3501-3503 (1982)
- Federal Alcohol Administration Act, 27 U.S.C. §§ 201-219a (Supp. 1989)

OREGON STATUTES

- Motor Vehicle Dealerships, ORS 650.120 (2003)
- Motor Fuel Franchises, ORS 650.200 (2003)
- Recreational Vehicle Franchises, ORS 650.300 (2003)
- Farm Equipment, ORS 646.415 (2003)
- Malt Beverages, ORS 474.005 (2003)

E. Business Opportunity Laws, General Dealer Laws, and Related Laws.

The U.S. state and federal business opportunity laws also vary in their scope, but generally require pre-offering disclosure and registration of offers of assistance or marketing plans to enable others to establish a business, with or without a trademark license.

As stated above, if a dealer or distributor is prohibited from using a supplier's trademark, there is no franchise law coverage in most states. However, even if distributors or dealers are not franchises, they may be subject to business opportunity registration and disclosure laws. About 35 states have business opportunity laws that require registration of the offer of a business opportunity, and preparation and delivery of a disclosure statement to prospective purchasers. Compliance also frequently involves posting a bond or cash deposit. The FTC Rule also has a limited definition that applies to certain types of business opportunities.

Business opportunities are defined in many different ways in various state laws and under the FTC Rule. They may include relationships in which a seller, supplier or licensor receives a payment to assist a purchaser to start a business, and: (i) represents that the purchaser will or may earn an amount in excess of the initial consideration paid, or (ii) guarantees sales or earnings, or (iii) promises to purchase goods or services of the buyer, or (iv) promises to find locations for the buyer, or (v) gives a money-back or satisfaction guarantee, or (vi) provides a marketing plan or marketing assistance. Therefore, a state-by-state analysis is necessary to determine whether a supplier can avoid the application of the business opportunity laws. Many state business opportunity laws may apply to franchises as well.

In Washington, a covered business opportunity includes any one of elements (i), (ii), (iii), (iv); and (vi), but only if the seller represents that profits will exceed the initial payment. See RCW 19.110 *et seq.* By way of comparison, Oregon has legislation regulating unlawful trade practices, ORS 646.605, but does not have a specific statute regulating business opportunities.

Whether a supplier or licensor can avoid the application of the business opportunity law therefore depends on which state law applies. In some states it may be sufficient to not provide projections or pro formas of income, or if they are provided, to disclaim conspicuously any representation or guaranty of profits or earnings, and to avoid finding locations and purchasing or buying back goods or services of the buyer. In other cases, most distributors and licensees are covered.

Many states also have laws that require that certain notices be given before termination of commissioned agents, and that otherwise protect agents from unreasonable action by their principals. Many states regulate the sale of multi-level marketing plans in various ways. Franchises and distributorships may be covered under these multi-level marketing plans if they permit sub-franchising or recruiting of other franchisees or distributors. A few states, including Arkansas, Wisconsin, New Jersey, and Puerto Rico have laws that protect nearly all dealers, distributors and franchisees from termination and similar actions by suppliers and trademark licensors.

III. SELECTED WASHINGTON CASES

The analysis of whether a distributor or a dealer is a franchisee under law frequently focuses on whether there is a “franchise fee” being charged. The FTC Rule defines a franchise fee very broadly. The intention is to cover all required payments. The only exception is a payment made at a bona fide wholesale price for reasonable amounts of merchandise for resale. There are important differences among the states, however. For example, in California, lease payments are franchise fees, while in Washington they may not be if at “fair market or rental value.” Cal. Corp. Code § 31005; RCW 19.100.010. Many distributorship, dealership or license agreements require the payment of a fee within the meaning of these state laws. See Boat and Motor Mart v. Sea Ray Boats, Inc., 825 F.2d 1285 (9th Cir. 1987) (the California Franchise Investment Law (“CFIL”) might be applicable to a direct dealer agreement between a manufacturer and its retail boat dealer, because various payments from the dealer might be a franchise fee, including payments for promotional material and equipment.) See also Blanton v. Mobil Oil Corp., 721 F.2d 1207 (9th Cir. 1983) (under WFIPA, gasoline dealer’s purchase of inventory from a supplier may be an indirect franchise fee if charges are unreasonable).

A number of Washington cases have decided the issue of whether a hidden franchise fee exists in a relationship that was not intended to be a franchise. These cases turn on their individual facts, and the unique and rather narrow statutory definition of franchise fee.

In the case of Blanton v. Mobil Oil Corp., 721 F.2d 1207 (9th Cir. 1983), the court held that an arrangement by Mobil Oil Corp. by which it charged excessive prices for tires, batteries and accessories could constitute a disguised franchise fee, under Washington law. The court overruled a summary judgment that had been entered in favor of the defendant Mobil, and remanded the case to the trial court to determine whether there had been excessive charges.

In the case of Craig D. Corp v. Atlantic Richfield Company, 45 Wn. App. 563, 723 (1986), the Washington Court of Appeals found that a real estate rental charge imposed by ARCO on its Mini Mart operators constituted a disguised franchise fee. The court found after a trial on the issue that the rental charge was higher than a fair market value for similar property. The appellate court remanded to the trial court to determine damages.

On the other hand, two cases applying Washington law found no franchise fee. In Lawrence G. Gordon, Inc. v. Brandt, 545 F. Supp. 1144 (W.D. Wa. 1983), the U.S. District Court in Washington held that as a factual matter there were no overcharges on the purchase from the franchisor of his equipment for resale by the franchisee. The Court found that an independent district manager for a manufacturer of money processing equipment was not a franchisee since there was no franchise fee proven. The court seemed to assume that it was the alleged franchisee’s burden to prove that a franchise fee was paid. However, RCW 19.100.220 provides that the burden of proving “an exception or an exemption from definition is upon the person claiming it.”

In American Oil Co. v. Columbia Oil Co., 88 Wn.2d 835 (1977), an independent petroleum products distributor purchased tires, batteries and accessories and fuel oils from American, and rented a sign and credit card imprinter from American. The court ruled as a matter of law that the WFIPA did not apply. The Court assumed that Columbia paid the bona

vide wholesale price and fair rental value for these items, which therefore excluded these payments from the definition of a franchise fee.

In Corporate Resources, Inc. v. Eagle Hardware & Garden, Inc., 62 P.3d 544 (2003), the Washington Court of Appeals held that an installation company (“CRI”) that performed home improvement installations for customers of a home improvement company (“Eagle”) failed to establish that it paid pay a franchise fee to Eagle and therefore the parties’ relationship did not constitute a franchise under WFIPA. Under the terms of the parties’ arrangement, CRI performed services for Eagle’s customers and Eagle paid CRI for its labor and installation costs based on a schedule that the parties negotiated at the inception of their agreement. For most jobs performed by CRI, Eagle would charge its customers an additional fee on top of the costs it paid CRI. In determining that the parties’ relationship was not a franchise, the court found that there was no evidence that CRI provided installation services for Eagle at a rate lower than what it would have provided had Eagle not marked up its services to Eagle’s customers. The court explicitly refused to characterize Eagle’s profit margin on CRI’s services as a franchise fee since such an interpretation would be tantamount to converting the entire construction industry into a franchise.

Don Koellen v. Snap-On Tools Corp., et al., Bus. Franchise Guide (CCH) 11,426 (E.D. Wa. 1998), is another Washington decision dealing with the payment of a franchise fee. In this decision, the court granted summary judgment to the defendant stating that a sales representative for a computer software supplier servicing automotive repair shops did not pay a franchise fee to the supplier within the meaning of WFIPA and, therefore, was not a franchisee. Although the sales representative alleged that the supplier had unilaterally withheld portions of commissions due in exchange for the privilege of selling the supplier’s products, the representative had not presented any evidence to support these allegations. In contrast, the supplier had presented evidence indicating that the deductions from the commissions were “charge backs” for commissions paid on accounts that were canceled prior to the end of the subscription period, not payments for any rights, goods, or services provided to the representative by the supplier. In essence, the supplier alleged that it had done no more than loan money to the representative in anticipation of customers’ payments of their accounts in full. Loans are not considered franchise fees under WFIPA.

IV. SELECTED OREGON AND CALIFORNIA CASES

The Oregon Franchise Act (“OFA”) is similar to the franchise statutes of both Washington and California in that it requires the same three basic elements (a prescribed marketing plan, substantial association with a trademark, and payment of a fee). However, there are subtle differences in the definitions. For example, the OFA does not use the term “franchise fee,” but instead provides that the third element is satisfied when a “franchisee is required to give to the franchisor valuable consideration for the right to transact business...” ORS 650.005(4)(c).

There are no published cases discussing what constitutes a franchise under the definition provided in the OFA. In one unpublished decision, Hammel v. Roadway Package Systems, Inc., 121 F.3d 715, 1997 WL 464113 (9th Cir. 1997), the plaintiff, Hammel, asserted that Roadway Package Systems (RPS) had defrauded him and violated the Oregon Franchise Act. Hammel argued that he had paid an indirect franchise fee because RPS took a portion of the fees paid by

customers for delivery services he provided. The court rejected his claim and ruled that the OFA did not apply because “Hammel was never entitled to the delivery fees and thus did not pay RPS a percentage of his earnings; rather, RPS paid Hammel a portion of the delivery fees for each package he picked up or delivered.” Id. at 2. The court also rejected his claim that providing discounted goods and services was equivalent to paying a franchise fee. Id.

The California Franchise Investment Law (“CFIL”), Cal. Corp. Code § 31005, also defines a franchise as having three elements (a prescribed marketing plan, substantial association with a trademark, and payment of a fee). In People v. Kline, 168 Cal.Rptr 185 (Cal. App. 1980), the California Court of Appeals dealt with the issue of what conduct was sufficient to meet the “marketing plan” element of the CFIL. In this case, the defendant had sold a “business opportunity” to operate hot dog kiosks. The court found that even though no fully prescribed and detailed marketing plan or system existed, the seller had agreed orally to assist in advertising and to supply food and menu planning, was to provide identifiable and distinctive kiosks, and had entered a written agreement to provide “total and continuing support.” The court determined that these factors were sufficient to imply a prescribed common marketing plan or system. Id. at 188.

In another California case, the court considered the issue of what constitutes “substantial association” with a trademark. In Kim v. Servosnax, Inc., 13 Cal.Rptr.2d 422 (Cal. App. 1992), the court found that a licensee’s business of operating a cafeteria on the premises of a host company that had contracted for food service with the licensor was “substantially associated” with the symbols of the licensor so as to qualify as a “franchise” under CFIL, even though the licensee was prohibited from using the licensor’s name with actual patrons of the food service facility. The court determined that the host company could be deemed a customer of the licensee to whom the name of the licensor was communicated. Id. at 428-429.

V. OTHER EXAMPLES OF AGREEMENTS TO REVIEW FOR FRANCHISE LAW PURPOSES

Whether licensing or distributorship agreements can be made “franchise-proof” often depends upon the definition or definitions of a franchise applicable, the availability of certain exemptions and exclusions, and willingness to modify the agreement to qualify for these exemptions and exclusions.

Businesses must be especially careful to consider the applicability of franchise issues in:

- (1) Trademark license agreements, especially those with marketing assistance;
- (2) Dealer and distributorship agreements, especially those that involve use of a unified trademark on products or services, and that require payments to the supplier for anything other than products for resale;
- (3) Joint ventures and “strategic alliances”, especially those that involve use of a unified trademark;
- (4) While rather rare, retail subleases with co-branding using a unified trademark, and percentage rent, plus marketing assistance;

- (5) Business start up consulting offers, with or without permission to use the sellers' trademark.

Beware of blanket choice of law provisions in the above contracts, including international agreements, which might inadvertently make applicable a state franchise law applicable.

VI. ENFORCEMENT AND RISK OF NON-COMPLIANCE

The FTC Rule has not been held by any court to provide a direct private remedy to a disgruntled franchisee. However, one court has held that a plaintiff could recover under the FTC Rule after the FTC itself has ordered enforcement action. Other courts have used the state "little FTC acts," which incorporate the federal FTC Act, in order to find a violation of the FTC Rule. In addition, the FTC has enforcement power and can impose fines of up to \$10,000 per day, restitution, and criminal sanctions.

State franchise laws usually include remedies such as damages to franchisees, rescission (return of fees and charges paid and voiding of the contract,) trebling of actual damages sustained by franchisees in the discretion of the court, and awarding of reasonable attorney's fees and litigation costs. Violation of these statutes is also frequently a crime. Personal, civil, and criminal liability usually exist under the franchise law for responsible officers, directors and managers.