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Franchise Law 101

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Presentation to University of Pittsburgh

Katz Graduate Business School

January 20, 2015

Franchising is Big Business

- 1 out of every 9 retail dollars spent in the United States every day is spent at a franchised business.
- Fully 13 percent of the private non-farm jobs in the United States are at franchised businesses.
- 7-Eleven, one of the largest franchisors in the world, opens a new franchised outlet every **3.5 hours** worldwide.

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The Inadvertent Franchise

- “Legal terms often have specialized meanings that can surprise even a sophisticated party. The term ‘franchise’ . . . is one of those words.”—United States Seventh Circuit Court of Appeals (1999).

Error Can Be Costly

- Many manufacturers and suppliers are all too often surprised and dismayed to learn that their distributorship relationships are subject to franchise laws.
- Very prominent example is a 1999 jury case where a jury awarded $1.525 million to a terminated Mitsubishi forklift distributor due to a violation of the Illinois franchise law.

So . . . how do you know?

The Law Defines It.

Hello. Don't worry. We're from the government, and we're here to help.

FTC Rule

- A franchise is a "continuing commercial relationship" with <u>all</u> three of the following elements:
  - Trademark
  - Significant Control or Assistance
  - Fee or Payment
- Found at 16 C.F.R. Part 436
- The FTC's own compliance guide runs **154** pages.

Trademark

- The franchisee is allowed to offer, sell or distribute goods, commodities, or services which are identified by a trademark, service mark, trade name, advertising, or other commercial symbol.

Significant Control

- The franchisor exerts significant control or assistance over the franchisee's method of operation.
- Usually accomplished through both the franchise contract and a franchise system operating manual.

Fee or Payment

- The franchisee is required to pay a fee to the franchisor or its affiliates of $500 or more (other than for bona fide wholesale prices for inventory) at any time before or within six months after commencing operations of the business.

But Wait! There's More

State Franchising Rules

- May be narrower or broader than the FTC Rule.
- All states involve the use of franchisor's trademarks, trade name or symbols.
- Generally fall into one of two categories:
  - Marketing Plan
  - Community of Interest
- Pennsylvania, like a majority of states, does not have a state franchise law.

Marketing Plan States

- Franchisor grants the franchisee the **right to engage** in a business pursuant to a “marketing plan or system” prescribed by the franchisor.
- Content required is often not clearly defined.
- Example states: Illinois and Indiana.

Community of Interest States

- Franchisor and franchisee share a “community of interest” in the marketing of goods or services.
- Parties have a common, continuing financial interest in the operation of the franchised business or sale of the franchisor’s products.

Community of Interest States

- The interest may be manifested in the franchisee's dependence on the sale of the franchisor's products, the franchise-specific goodwill created by the franchisee, or merely the franchisee's acquired knowledge of the franchisor's products.
- Examples: New York, Connecticut, Missouri, New Jersey, Delaware & Arkansas

Related State Business Laws

- Special Industry Laws: Statutes that regulate the relationship between manufacturers/suppliers and distributors and dealers.
  - Examples: liquor, motor vehicle, farm equipment, petroleum, and outdoor power equipment dealerships.

Related State Business Laws

- <u>Relationship laws</u>: if a franchise relationship is established under state law, a number of states impose special duties on substantive aspects of the business relationship, such as a termination, transfer, cancellation and non-renewal.

State Relationship Laws

- Designed to protect franchisees from being treated unfairly.
- States with relationship laws: Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Idaho, Illinois, Indiana, Iowa, Maryland, Michigan, Minnesota, Mississippi, Nebraska, New Jersey, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.

Business Opportunity Laws

- “Franchise-lite”
- FTC rule and state laws that cover business opportunities like vending machine routes, rack display operations (e.g., magazines, candy), 900 number ventures, medical billing ventures, and most work-at-home ventures.
- Final FTC Amended Rule became effective March 1, 2012.
- Requires a simplified disclosure of 5 key important items.

FTC Business Opportunity Rule

- Seller's identifying information;
- Earnings Claims;
- Legal/Litigation History;
- Cancellation/Refund Policy; and
- A List Containing Purchasers for the past 3 years.

What does this all mean?

- Disclose, Disclose, Disclose
- Protections afforded by franchise laws generally cannot be waived, even if there is contract language
- to the contrary!

Franchise Disclosure Document

- Better known as the "FDD" (used to be known as the Uniform Franchise Offering Circular ("UFOC").
- The FDD is a comprehensive, pre-sale disclosure document that must be provided to a prospective purchaser of a franchise.
  - 23 different items must be including, ranging from identification of franchisor to intellectual property
- This disclosure requirement applies in all 50 states.

Key Elements of FDD

- Business Experience of Franchisor (Item 2)
- Material Litigation of Franchise System (Item 3)
- Estimated Initial Investment (Item 7)
- Obligations of Franchisee (Items 9, 14)
  - Often includes things like non-competes

Key Elements of FDD

- Terms of renewal, termination, transfer and dispute resolution (Item 17)
- Restrictions on what a franchisee may sell (Item 16)
- Fair financial performance representations (Item 19)
- Plain Description of System (Item 20)

State Requirements

- In “registration states”, a franchisor must register its documents with the state **before** offering a franchise for sale.
- CA, HI, IL, IN, MD, MI, MN, NY, ND, RI, SD, VA, WA, WI.

Examples of Inadvertent Franchises

- Air Conditioning Dealer
- Appliance Dealer
- Copy Machine Distributors
- Furniture Dealers
- Lubricant Distributors
- Sales Representatives (especially in states like CT that do not require a franchise fee)
- Slot Machine Distributor
- Common bottom line: many “dealerships” and “distributorships” are hidden franchises

Consequences of Non-Compliance

- Risk of Substantial Civil and Criminal Penalties from federal and state enforcement.
- No "private right to enforce" under FTC Rule; however, state laws do often include a private right to enforce state law or the FTC rule in state court.
- FTC Rule, moreover, imposes liability on officers and directors, and state laws often make that liability joint and several.

Ignore Law at your Peril

- Globe Distributors v. Adolph Coors Co.
- New Hampshire—not a registration state—but has a state statute requiring notice and opportunity to cure before a distributorship may be terminated.
- Coors terminated for nonpayment without notice, as provided in contract.
- Jury awarded double damages of $10.2 million for wrongful termination.

Franchise Contract

- Formal Franchise Agreement (the Contract)
  - Often tracks the FDD
  - Binds franchisee to system requirements and operations
  - Usually involves system operating manual (updated regularly), including financial reporting and computer software requirements

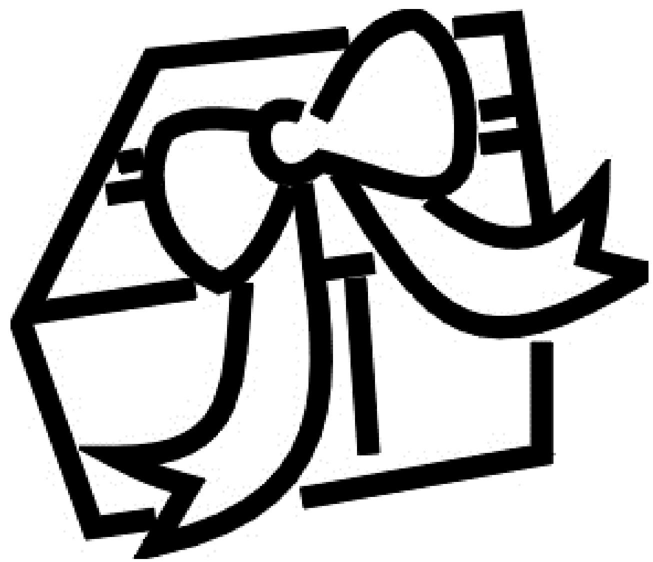
Franchise Contract

- Beginning or end of relationship is when to negotiate special terms
- Important to use due diligence and choose successful (or high potential) franchise opportunities
- Franchisee success is tied to franchisor success to a significant degree.

Selected Issues in Franchising

Taxation

- And, on the Fifth Day of Christmas, my true love sent to me . . . a new franchise tax law opinion from the Iowa Supreme Court.



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Taxation

- On December 30, 2010, the Iowa Supreme Court affirmed the power of states to impose income taxes on royalties paid by franchisees to out-of-state franchisors.
- The Court found that the use of KFC's intangible intellectual property (images of Col. Sanders, the red and white bucket, etc.) by its franchisees within the physical confines of the state of Iowa presents "a sufficient connection to Iowa to amount to the functional equivalent of 'physical presence'".
- Issue to watch as states have strapped budgets and are searching for revenue—Georgia, Alabama and Mississippi have introduced legislation.

Taxation

- Amazon.com
  - New York State case
  - Amazon has no physical location in state
    - Traditional test for due process
  - NY Courts found that contracts between New York businesses and individuals for commissions was sufficient
  - 2014: US Supreme Court refused case

Taxation

- Franchisor vs. Franchisee
  - Each Franchise is its own, independent business.
  - Some—and a growing number of franchises—are so-called “master” or “area” franchisees.
  - All of the responsibilities of running an independent business apply

Labor Issues

- Or, Who is the employer?
- Unions want to organize franchises
  - They don't want to go franchisee by franchisee
  - Costly and time-consuming
  - High turnover

Traditional Test

- Different Circuit Courts and State Supreme Courts have slightly different tests
- Generally: An employer must be able to meaningfully affect employment
  - Things such as hiring, firing, discipline, supervision and direction.

Enter the NLRB

- The McDonald's Complaints
  - NLRB Office of General Counsel has filed 13 complaints alleging that franchisors and franchisees violated the National Labor Relations Act
  - Wants to replace "meaningfully affect" standard with "sufficient control" standard
  - Nobody is quite sure what it means

What's Next?

- Stay Tuned
- One thing everyone agrees on: the NLRB Complaints present a huge challenge to the franchise business model

Immigrants and Franchising

- Over the last 20 years (ending 2012), 30% of new small business owners have been immigrants.
- Immigrants own fully 18% of all small businesses in the US.
- Immigrant-owned small businesses employ 4.7MM people in the US.

Immigrants and Franchising

- Many of those businesses are franchises.
- Most common route is the EB-5 Program
  - Provides conditional permanent legal residence, if
    - $500,000 investment in a “targeted area” or $1,000,000 investment elsewhere and
    - Creation of 10 verifiable, new, full-time jobs for U.S. citizens or legal residents
    - Resources may be pooled (ea. has 10 job rule)
    - After 2 years, condition may be lifted

Immigrants and Franchising

- Investment may be direct or through pooled investment vehicles
- Pooled vehicles are much like securities offerings.
- Investment fund then hires an operator, who then enters into the franchise agreement with franchisor

Immigrants and Franchising

- Another Potential Option: E-2 Visa
- Conditional Resident Card
- Good for 2 years
- Renewable indefinitely, so long as requirements continue to be met

Immigrants and Franchising

- E-2 Requirements:
  - Investor must be from a treaty country
  - Must be entering US solely for purpose of directing the operation of a business in which a “substantial amount of capital” has been invested
  - Same tracing requirements as EB-5
- No set amount; at least $100,000

Immigration

- Don’t forget L-1 (intercompany transferees), L-2 (spouses and unmarried children), H-1B (specialty workers) and H-4 (spouses and unmarried children) visas.
- Generally need to be sponsored by an employer and capped at 7 years.

Immigration

Bottom Line:
Franchising offers great opportunities for a foreign immigrant investor looking to emigrate to the U.S. Potential pitfalls mean with you need to work with an experienced franchisor and/or franchisee.

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Social Media

- 2009 FTC Report on Online Behavioral Advertising
- 4 Principles:
  - Transparency and Consumer Control
  - Reasonable Security and Limited Data Retention
  - Affirmative Express Consent for Material Changes to Existing Privacy Promises
  - Affirmative Express Consent to Using Sensitive Data

Key Elements of a Social Media Policy

- The franchisor must have a written social media policy and ensure that franchisees have a social media policy that is consistent with the franchisor's policy.
- The policy should be authorized in the franchise agreement and published in the franchise operating manual, or other document that controls the franchisee-franchisor relationship.
- Even for older franchise agreements that do not make specific mention of a social media policy, the provisions of a franchise agreement related to advertising, control and use of the franchise system's trademarks, preserving confidentiality, and termination and post-termination obligations all likely support the establishment of a social media policy.
- All franchisees (and employees, as applicable) should sign an acknowledgement of receipt of the policy.

Key Elements of a Social Media Policy

- Ensure that the policy provides that the franchisor owns any website, blog site, Twitter account, Facebook account, and/or any other site created on a social media platform involving the brand.
- Equally important, the policy must require franchisees to provide, and update, their franchisors with the then-current passwords for any social media involving the brand. This requirement is essential, should be included in any renewals of the franchise agreement, and should also be included in the list of franchisee obligations that survive any termination of the agreement.
- Examples abound of "orphan" social media websites or portals that can neither be accessed nor taken down because a non-cooperative or terminated and disappeared franchisee owns the site and/or the site's passcode is unknown.

Key Elements of a Social Media Policy

- Make social media policy consistent with the other types of rules of the franchise system regarding use and control of trademarks and copyrighted materials, and advertising. For example, a franchisor might wish to include policies regarding use of brand trademarks and logos on Twitter, Facebook and other social media sites.
- Disclose what types of monitoring the franchisor will perform. Specifically state that franchisees and employees have no expectation of privacy in information they post publicly and that any social media or internet sites that they access on work computers may be stored and/or reviewed by the company.

Key Elements of a Social Media Policy

- Make sure franchisees understand the need to be transparent. They should not take on the persona of any other person on social media, especially a customer, whether it is on your own site or any other site—particularly the site of a competitor. Violation of FTC regulations.

- Advise franchisees that they may not post anonymously when discussing matters related to the franchise system. In fact, some states, including Pennsylvania, have held that the names of anonymous posters to social media sites can be discovered if financial harm can be demonstrated.

Franchise Assignments in Bankruptcy

- § 365 of Bankruptcy Code
- Franchise Agreements are generally assignable
- Exception for Trade Mark Cases

Success

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