

## Fox Rothschild Podcast

### Featuring Litigation Partner John Gotaskie in Pittsburgh

*We are talking today about franchising and some of its real estate implications with John Gotaskie on Fox Rothschild Podcast. John is a partner and litigator with Fox Rothschild in Pittsburgh. He represents clients in diverse legal matters, including franchising and complex commercial litigation as well as creditor's rights and social media matters. John, good morning.*

**John Gotaskie:** Good morning. Thank you.

**Question:** *John, franchising is big business. Just how big?*

**John Gotaskie:** Very big. One out of every nine retail dollars spent in the United States every day is spent at franchised business. They're big and little names: not just restaurants that you might know like McDonald's and Subway but companies like Culligan Water Systems, Scott's Lawn Care, many janitorial services companies, many nail salons, many health care enterprises, tax preparation services, you name it. Every type of retail business can be franchised. About fully 13 percent of the private non-farm jobs in the United States are at franchised businesses. 7-Eleven, for example, one of the largest franchisors in the world, opens a new franchised outlet every 3.5 hours, on average, worldwide.

**Question:** *What makes a franchised business a franchised one?*

**John Gotaskie:** The FTC tells us. The Federal Trade Commission defines a franchise as a "continuing commercial relationship" that has all three of the following elements:

The first is a "Trademark" – that the franchisee is allowed to offer, sell or distribute goods, commodities or services that are identified by a trademark, or also service marks, trade names, advertising or some other commercial symbol. But the shorthand for that is a trademark.

Second is "Significant Control or Assistance." Here, the franchisor must exert significant control over or provide significant assistance to the franchisee's method of operation.

And the third is "Fee or Payment." The franchisee is required to pay a fee to the franchisor or its affiliates of \$500 or more at any time before or within six months after starting to operate the business, other than a purchase of *bona fide* inventory or things like that.

*Question: Do states have their own rules governing franchising?*

**John Gotaskie:** It depends. In a majority of states, including Pennsylvania, only the FTC Rule applies. For the second straight session, though, a proposed statute to regulate the sale and operation of franchised businesses in Pennsylvania has been introduced into the legislature in Harrisburg. As of today, though, that bill had been referred to committee and has not been passed out of committee just yet.

In other states, including New Jersey, state franchising rules and/or laws apply. The rules themselves may be narrower or broader than the FTC Rule, but they usually serve to broaden the rights of franchisee. Some states have a “registration” requirement; for example if a franchisor must register with designated state authority before offering franchises in that state. As you and I have discussed before, a failure to register in a registration state before offering franchises in that state may lead to significant financial and legal penalties for the franchisor.

*Question: John, what is a community of interest state?*

**John Gotaskie:** In a community of interest state, the franchisor and franchisee share what’s called a common, continuing financial interest in the operation of the franchised business or the sale of the franchisor’s products. That interest may be manifested in a number of ways, including the franchisee’s dependence on the sale of the franchisor’s products, franchisee-specific created goodwill or merely the franchisee’s acquired knowledge of the franchisor’s products. New Jersey and Delaware, to name two states close to Pennsylvania, are both community of interest states.

*Question: What are some aspects of New Jersey’s system?*

**John Gotaskie:** New Jersey’s system requires a written agreement for a definite or indefinite period in which a right to use a trademark or service mark is granted, in which there is a community of interest between the franchisee and franchisor, and a physical presence (for example, a place of business) in New Jersey. Gross sales between the franchisor and franchisee must be at least \$35,000 in the preceding 12 months, or at least 20 percent of the franchisee’s gross sales have to come from franchised products. Other states with state-specific rules are likely to have their own specific definition, so you need to carefully review each state’s regulations.

*Question: John, what is a so-called accidental franchisor?*

**John Gotaskie:** The accidental franchisor is a fairly broad definition. It can and does pull in businesses that are not what might be typically thought of as franchisees. As you might recall, we discussed the accidental franchisor trap in a previous podcast, and it’s a particular problem in registration states if you haven’t registered ahead of time.

***Question:** What is the impact on businesses which may not think of themselves as franchisors?*

**John Gotaskie:** This becomes an interesting problem. Again by way of example, specific rules on termination of franchisees in New Jersey make it much more difficult for franchisors to terminate a franchisee. In fact, in New Jersey, a franchisor must show good cause to terminate, to cancel, or to fail to renew a franchisee. Good cause is defined to be a failure by the franchisee to substantially comply with the requirements imposed on him by the franchise agreements. Disputes in this area typically lead to significant litigation — but landlords, for example, are likely to have a New Jersey franchisee tenant for a very long time.

***Question:** Getting to the crux of our topic today, what are the real estate implications for landlords that they may not know?*

**John Gotaskie:** Successful franchisors spend considerable time and money helping their franchisees choose what they expect will be successful locations based on a variety of factors including demographics, road access, parking and household income in the local area, just to name a few. Thus, they want to protect that investment of time in the site selection process.

Consequently, many, if not most franchisors will require their franchisees to obtain a lease addendum in favor of the franchisor from the landlord. This allows a franchisor to maintain some level of control over the chosen location and the franchisor's marks in the instance where the franchisee for example defaults and/or abandons the franchise. Alternatively, some franchisors prefer to enter into the lease with the landlord directly, and then sub-lease the premises to its franchisee. Many franchise agreements, consequently, contain cross default provisions: if a default is triggered under the franchise agreement, a default is also triggered under the sub-lease, and vice versa.

***Question:** Can you cite some specific issues that might arise for landlords with a franchised business as its tenant?*

**John Gotaskie:** There are quite a few. Among them are requirements respecting permitted uses of the franchised business location – for example, explicit agreements that would allow the ability to be remodeled and to fit the décor that would fit the franchise branding requirements. Another key right that will often be sought by the franchisor is the right to enter upon the premises of the franchisee for any purpose, including protection of marks. So that could be any time, any place the franchisor needs access to the location. Depending upon the franchise system, the franchisors may also require an affirmative statement of obligation to assist the franchisor from the landlord and/or limits on the right to assign the location of the franchised business, often making such assignment subject to approval from the franchisor.

*Question: Are there more?*

**John Gotaskie:** Sure. Others can include a requirement that a franchisor be notified in the event of default. The right of a franchisor to assume the lease or lease renewal terms. “No agency” clauses, where the franchisor is not the agent of its franchisee, are often put into lease addendums. You might also see a request that they have the right to obtain sales or other reports in the landlord’s possession. Again, they’re not asking that they be created, but if sales reports are given, the right to get copies of those.

The bottom line is that franchisors wish to protect their investment in that location, and they will seek a landlord’s help in doing so. Obviously, the issues discussed here are a laundry list of possible requests. The franchisor may not seek all of them, and certainly the landlord may not give them back to the franchisor. The final result will of course depend upon the strength of the location, how bad the franchisor wants to be there and the market power of the franchisor, vis-à-vis the landlord.

*Narrator: Well, thank you John. Listeners, to confidentially discuss these franchising issues impacting your business, please contact John at 412-394-5528 or at jgotaskie – that’s J-G-O-T-A-S-K-I-E – at foxrothschild.com.*

*Fox Rothschild LLP is a full service law firm built to serve business leaders, backed by 550 lawyers coast to coast. Our clients come to us because we understand their issues, their priorities and the way they think. We help clients manage risk, and make better decisions by offering practical advice. Visit us on the web at [www.foxrothschild.com](http://www.foxrothschild.com).*

# # # #