



Fox Rothschild Podcast

Featuring Litigation Partner John Gotaskie in Pittsburgh

We are talking about today about franchising with John Gotaskie on Fox Rothschild Podcast. John is a partner and litigator with Fox Rothschild in Pittsburgh. He represents franchisors in diverse legal matters, including franchisee relationships and social media counseling as well as complex commercial litigation and creditor's rights. John, good morning.

John Gotaskie: Good morning. Thank you.

Question: *Franchising certainly is a growing sector of our economy, is it not?*

John Gotaskie: That's right. One out of every nine 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, a franchise many of us know, and one of the largest franchisors in the world, opens a new franchised outlet every 3.5 hours worldwide.

Question: *Where are some of the legal pitfalls that you see in this sector?*

John Gotaskie: The United States Court of Appeals for the Seventh Circuit once said, "Legal terms often have specialized meanings that can surprise even a sophisticated party. The term 'franchise' . . . is one of those words." In my experience, many manufacturers and suppliers are all too often surprised and dismayed to learn that their distributor relationships are subject to franchise laws. One very prominent example is a 1999 case where a jury awarded \$1.525 million to a terminated Mitsubishi forklift distributor due to an inadvertent violation of the Illinois franchise law.

Question: *So, how do you know?*

John Gotaskie: The Federal Trade Commission, at least at the federal level, sets the rules. The FTC has a rule that a franchise is a "continuing commercial relationship" with all three of the following elements: trademark, significant control or assistance, and fee or payment.

Question: *So, tell us more about trademark element.*

John Gotaskie: Well, this means that a franchisee is allowed to offer, sell or distribute goods, commodities or services which are identified by a trademark, a service mark, a trade name, specific advertising or other commercial symbol.

Question: *How about the significant control aspect?*



John Gotaskie: There, it means that a franchisor must exert significant control or assistance over the franchisee's method of operation, usually through terms set forth in both a franchise contract and a franchise system operating manual.

Question: How about the fee or payment aspect?

John Gotaskie: This refers to a requirement that the franchisee must pay a fee to the franchisor or one its affiliates for \$500 or more (other than for *bona fide* wholesale prices for inventory) at any time before or within six months after commencing operation of the business.

Question: Is the federal government the only body that controls franchising? How about states?

John Gotaskie: Well, no, there are many states that have their own franchise statutes. They may be narrower or broader than the FTC Rule, but they generally fall into one of two categories: the Marketing Plan states or the Community of Interest states. Like most states, Pennsylvania, the state we're sitting in today, does not have a state franchise law.

Question: What about the states that do have franchise laws?

John Gotaskie: In the so-called "Marketing Plan" states, a 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, however. Examples of Marketing Plan states are Illinois and Indiana. In a "Community of Interest" state, franchisors and franchisees share a "community of interest," hence the name, in the marketing of goods or services. Parties have a common, continuing financial interest in the operation of the franchised business or in the sale of the franchisor's products.

Now this interest that we're talking about is most often manifested in the franchisee's dependence on the sale of the franchisor's products, franchise-specific goodwill created by the franchisee, or merely the franchisee's acquired knowledge of the franchisor's products. Examples of these states are New York, Connecticut, Missouri, New Jersey, Delaware and Arkansas.

Question: What are business opportunity laws?

John Gotaskie: I call business opportunity laws "*Franchise-lite*" laws. They are FTC rule and state laws that cover business opportunities other than franchises, often things like vending machine routes, rack display operations such as magazines or candy, and medical billing ventures, which with the outsource of medical billing is big in this country. These opportunities are currently subject to an ongoing federal rulemaking process, so they are an area to watch.

Question: What does this all mean for franchisors?

John Gotaskie: Disclose, disclose and then disclose again. The fact is that the protections afforded to franchisees by franchise laws and they generally cannot be waived, even if there is contractual language that would do so.



Question: *How does one disclose?*

John Gotaskie: The main way to disclose is through the Franchise Disclosure Document. This is better known as the “FDD,” and it is a comprehensive, pre-sale disclosure document that must be provided to a prospective purchaser of a franchise. Twenty-three different items must be in the FDD, including a range of things from identification of franchisor to intellectual property to financial information. And this disclosure requirement is a federal law that applies in all 50 states.

Question: *Are the Franchise Disclosure Documents difficult to complete?*

John Gotaskie: It depends. The FDD in fact is an artful collection of detailed information about the Franchise System and its financial performance. When drafting FDDs, I have found that prior experience and know-how count. There are some large, sophisticated franchisors that handle production and updating the FDD in-house, but most franchisors and prospective franchisors could stand to benefit from expert guidance.

Question: *Are FDDs mandatory?*

John Gotaskie: Yes, the FDD is required by the FTC Rule.

Question: *Do franchisors need to be registered with the government like securities dealers?*

John Gotaskie: That’s only true in “registration states.” In those states, which are a minority of the states, but are some of our largest commercial states such as Illinois and Virginia, a franchisor must register its documents with the state *before* offering any franchise for sale. There are 14 of those states.

Question: *Can you provide some examples of inadvertent franchises?*

John Gotaskie: Sure. Primarily, if you look at case law, it’s dealers and distributors. They might range all across industries, from air conditioning, appliances and copy machines to furniture, lubricants and sales representatives. The sales representative trap is particularly true in states like Connecticut that do not require a franchise fee to be a franchise. They also might include slot machine distributors, and as gaming grows across the country, that’s a big issue. The common bottom line is that “dealerships” and “distributors” *may be* hidden franchises and *could be* at risk, because the law of course provides the protection of franchisees whether or not the contract says so. So, dealers and distributors need to check and really know for certain.

Question: *What are the consequences of non-compliance for a franchisor?*

John Gotaskie: There is a risk of substantial civil and criminal penalties from federal and state enforcement, including the rescission of the franchise and lost royalty income devolving from that lose franchise. There is no “private right to enforce” the law under the FTC Rule, so this has to be done by the federal government. On the other hand, the state laws that are out there do often include a private right to enforce state law or the FTC rule in state court. The FTC Rule, moreover, imposes liability on officers and directors of the franchisor, and the state laws often make that liability joint and several.

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Question: Why not just conveniently ignore these laws?

John Gotaskie: As with anything else in our society, you ignore the law at your peril. Take the case of *Globe Distributors v. Adolph Coors Company* from New Hampshire. Although New Hampshire is not a registration state, it has a state statute requiring notice and opportunity to cure before a distributorship may be terminated. A jury found that Coors terminated the Globe Distributorship for nonpayment without providing the specific required notice and then awarded double damages to the franchisee of \$10.2 million for wrongful termination.

Question: Aren't these issues already covered in contracts such as distributor agreements?

John Gotaskie: A formal franchise agreement will often track the FDD. That's true. It binds a franchisee to system requirements and operations. It usually involves a system operating manual (that's updated regularly, often on an annual basis), including financial reporting and computer software and Internet use requirements, but if the franchisor has not specifically studied the FDD, it might not be in a distributor arrangement otherwise.

Question: Are these contracts negotiable?

John Gotaskie: From the franchisee and franchisor perspective, the beginning or end of a relationship is often the time to negotiate special terms. It may be important for a prospective franchisee to use due diligence and choose successful (or high potential) franchise opportunities. Similarly, a franchisor is going to want to pick franchisees who have the opportunity to be high performers as well. But at the end of the day franchisee success is often tied to franchisor success, so both sides have an interest in choosing the right people.

Question: Are there any tax issues franchisors need to know about?

John Gotaskie: There are always tax issues when talking about business opportunities, and there's a recent one that everyone should be paying attention to. Last December, 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 in this case of KFC's intangible intellectual property (for example the images of Col. Sanders and the red and white bucket used at Kentucky Fried Chicken outlets) by its franchisees within the physical confines of the state of Iowa present "a sufficient connection to Iowa to amount to the functional equivalent of 'physical presence'" for the imposition of tax. This is an issue to watch as states have strapped budgets and are searching for revenue.

Narrator: Well, thank you, John. To receive a copy of John's white paper on franchising, or to discuss any aspect of the industry, please contact John at 412-394-5528 or at *jgotaskie* – that's J-G-O-T-A-S-K-I-E – at *foxrothschild.com*.



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