The Broad Scope of Franchise Laws:
Traps for the Distribution Contract Drafter

by Andre R. Jaglom[*]

The number of U.S. states enacting laws restricting a franchisor's sale or termination of franchises has increased over the years.[1] An understanding of the existing laws is important for every supplier and distributor of goods and services, because such statutes have been held to apply to far more than the traditional fast food hamburger operation. In some states, for example, if a supplier of a branded product merely requires a distributor to maintain a 90-day inventory and participate in a promotional program, a "franchise" under the applicable statutory definition may exist, with disclosure and registration requirements imposed on the supplier and extensive rights granted by law to the distributor. The supplier's failure to comply can lead to serious penalties.

Moreover, the scope of these laws is by no means limited to the retail level or to consumer goods and services. Cases have held industrial product distributors to be protected by state franchise statutes,[2] and one state has ruled that an out-of-state law firm contemplating partnership with a local firm was engaged in the sale of a franchise.[3] Even sales representatives who never take title to product and have no authority to enter binding sales contracts may be protected by franchise laws.[4] Perhaps the best example of the breadth of such laws is the 2011 Seventh Circuit decision applying the Wisconsin

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1 In 2007, for example, a new general business franchise law was enacted in Rhode Island. Some two dozen jurisdictions in the United States have such statutes, and many states have statutes governing the sale of business opportunities and distributorships in specific industries. Franchise laws outside the U.S. are beyond the scope of this article, but other countries also regulate the sale of franchises in various ways.

2 *Hydro Air of Connecticut, Inc. v. Versa Technologies, Inc.*, 599 F. Supp. 1119 (D. Conn. 1984) (applying Connecticut Franchise Act to distributor of hydraulic and pneumatic systems and components).

3 State of Washington, Department of Licensing, Administrative Opinion, File No. E-12978, Feb. 7. 1989, *cited in* K. Lambert & C. Miller, *The Definition of a Franchise: A Survey of Existing State Legislative and Judicial Guidance*. 9 FRANCH. L.J., Fall 1989, No. 2 at 3, 5. The State reasoned that the use by the branch office of the out-of-state firm's name was a license of a trademark, the capital contributions of the local partnership constituted a franchise fee, and there was a community of interest between the local and out-of-state firms by reason of their proposed partnership, thus satisfying the three elements of the Washington franchise law.

4 *See Gentis Business Systems, Inc.*, 71 Cal. Rptr 2d 122, 98 Cal. Daily Op. Serv. 527 (Cal. Ct. App. 1998) (where representatives paid supplier a fee, operated under prescribed marketing plan, and operation was substantially associated with supplier's trademark, they met statutory definition of franchisee despite never taking title or making deliveries and lacking authority to enter binding sales agreement, as solicitation of orders constituted offering of goods). *But see George R. Darche Associate v. Beatrice Foods Co.*, 538 F. Supp. 429, 434 (D.N.J. 1981), *aff'd* 676 F.2d 685 (3d Cir. 1982) (in absence of right to enter binding contract, representative was not engaged in offering, selling or distributing and so was not a franchisee).

Fair Dealership Law to the Girl Scouts to prevent the dissolution of a local chapter without good cause.[5]

The legislative motivation behind the franchise laws is much the same as that behind the securities laws, but the protection afforded often is even broader: the franchisee is viewed as an investor entitled to certain information and safeguards. Violation of these statutes is usually a criminal offense and gives rise as well to civil liability of the franchisor to injured franchisees.

A. *General Form of Statutes*

The statutes take one or both of two general forms – (1) disclosure and registration requirements, and (2) restrictions on termination and other substantive aspects of the distribution relationship. The theory of the disclosure and registration laws is that the franchisee should be given essential information regarding what is considered to be his business "investment." The theory underlying the anti-termination laws is that a distributor who has invested in a supplier's brand and has built up a market should be protected from a supplier's decision to yank the rug out from under him by giving the now-established market to another distributor or taking it over directly.

B. *The FTC Rule*

Analysis of disclosure laws can profitably begin with the Federal Trade Commission ("FTC") Franchise Rule.[6] On January 23, 2007, the FTC announced that it had approved amendments to the Franchise Rule effective July 1, 2007.[7] As of July 1, 2008, franchisors were required to comply with the amended Franchise Rule.[8]

The amended Franchise Rule applies only to franchises, while the original Franchise Rule applied to both franchises and business opportunities. As part of its 2007 amendments, the FTC retained the text of the original Rule as it applied to business opportunity ventures and created the Business Opportunity Rule,[9] independent of the

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5 *Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the United States of America*, 646 F.3d 983 (7th Cir. 2011). The Court rejected the argument that the Wisconsin Fair Dealership did not apply to non-profit entities, finding that "[f]rom a commercial standpoint, the Girl Scouts are not readily distinguishable from Dunkin' Donuts." *Id.*at of 987.

6 16 C.F.R. Part 436.

7 FTC Issues Updated Franchise Rule (Jan. 23, 2007), *available at* http://www.ftc.gov/opa/2007/01/franchiserule.htm.

8 Under the original FTC Rule, franchisors' authorization to use the UFOC Guidelines of the North American Securities Administrators Association ("NASAA") to comply with disclosure requirements was granted on the grounds that the UFOC Guidelines provided equal or greater consumer protection as the original Rule. However, permission to use the UFOC Guidelines was withdrawn effective July 1, 2008 because, as a result of amendments to the Franchise Rule, the UFOC Guidelines as in effect on January 23, 2007 no longer provided prospective franchisees equal or greater protection as the Franchise Rule. On June 6, 2008, NASAA adopted the disclosure requirements of the amended FTC Franchise Rule and published the *NASAA 2008 Franchise Registration and Disclosure Guidelines (amended and restated Guidelines)* (the "2008 Guidelines"), which became effective on July 1, 2008. Although it is expected that all franchise filing states will eventually adopt the 2008 Guidelines (in some cases with individual state modifications), only Maryland and Wisconsin have expressly done so. Several other states, including Minnesota, New York and North Dakota, have provided links to the 2008 Guidelines on their official websites, implicitly adopting them.

9 16 C.F.R. Part 437.

Franchise Rule. The FTC issued a separate Notice of Proposed Rulemaking regarding the appropriate scope of disclosure for business opportunities,[10] but pending completion of that rulemaking process business opportunities governed by the original Rule shall be governed by the Business Opportunity Rule. The FTC Rule applies nationally,[11] and merits study also because its definitions of the relationships covered are similar to those in many of the state franchise and business opportunity laws.

1. *Franchises*

The "franchise" definition has three basic elements. First, there is a trademark or brand identification element. The relationship must either involve the sale of goods or services identified with the franchisor by a "trademark, service mark, trade name, advertising or other commercial symbol" (a "product franchise") or the franchise must be operated under a name using the franchisor's mark (a "business format franchise").[12] The sale of a branded product in the hypothetical example in the opening paragraph would satisfy the product franchise trademark element. McDonald's restaurants, for example, satisfy the business format franchise trademark element.

Second, there is a marketing or operations element. Either the supplier has significant control over the franchisee's method of operation or it provides significant assistance to the franchisee with respect to that method of operation. The required participation in a promotional program in the opening example could constitute this element. Of course, in the traditional business format franchise, the supplier's control over the method of operation can be much more extensive, down to architecture and floor plans, products carried, accounting procedures and employee dress codes. Far less control than this, however, may be enough to meet the marketing element of the franchise definition. In the industrial products context, for example, requirements

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10 FTC Notice of Proposed Rulemaking, 71ed. Reg. 19054 (April 12, 2006), *available at* http://www.ftc.gov/opa/2006/04/newbizoprule.htm. The proposed new business opportunity rule would broaden the coverage of the rule by eliminating the $500 minimum fee requirement from the definition of a business opportunity and applying the rule to all arrangements where there is a solicitation to enter into a new business, payment of any consideration, whether directly or indirectly, and either earnings claims or the promise of business assistance. The new rule is intended, among other things, to cover work-at-home and pyramid marketing schemes that have posed a chronic fraud problem. The proposed rule would replace the extensive twenty part disclosure required of franchise offerings with a one-page disclosure addressing only five items: (i) whether the seller makes any earnings claims (in which case an additional Earnings Claims Statement substantiating the claims would be required); (ii) a list of any criminal or civil actions against the seller or its representatives involving fraud, misrepresentations, securities or deceptive or unfair trade practices; (iii) whether the seller has cancellation or refund policies and the terms of those policies; (iv) the total number of purchasers in the last two years and the number of those purchasers seeking a refund or to cancel in that time period; and a list of prior purchaser references. The proposed rule would prohibit misrepresentations about certain specified material terms of the business relationship; the use of shills as references; misrepresentations of endorsements or testimonials; failure to honor territorial protection guarantees; and failure to honor refunds.

11 The amended Franchise Rule states that the offer or sale of a franchise to be located in the United States is subject to the disclosure requirements of the Franchise Rule. 16 C.F.R. § 436.2. The 11th Circuit has so held under the original Rule. *See, e.g. Niemann v. Dryclean U.S.A. Franchise Co., Inc.*, 178 F. 3d 1126 (11th Cir. 1999), *cert. denied*, 120 S. Ct. 938 (1999).

12 Under the amended Franchise Rule, this element is restated as: "The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark." 16 C.F.R. § 436.1(h)(1).

relating to service facilities, technical staff or customer support might suffice. Other conduct that might meet this requirement includes advertising by the franchisor, mandatory training, sales quotas, use of an operations manual, or regulation of hours of operation, decor, staff uniforms and the like.

Third, there is a franchise fee element, consisting of some payment to the franchisor or an affiliate of $540 or more (other than a bona fide wholesale price for merchandise) within the first six months. Traditionally, this fee element is met by either an up-front franchise fee required to open the business or a royalty based on a percentage of sales. But again, the scope of the FTC Rule – and of many state laws – is far broader. A franchise fee can include rent, required advertising payments, payments for initial equipment or inventory, fees for training seminars or security deposits, or a fee to keep a territory exclusive.[13] A 90-day inventory requirement, if not reasonably necessary to the business, may constitute a franchise fee, as may payments for parts and repair manuals.[14]

2. *Business Opportunities*

The definition of "business opportunities" in the original FTC Rule, and as of July 1, 2007, the Business Opportunity Rule, also has three elements. First, the buyer of the opportunity sells goods or services supplied by the seller. Second, the seller secures or helps the buyer to secure outlets for the goods or services or sites for vending machines or rack displays. Finally, as with franchises, there is a fee or other payment. As noted above, this definition would change substantially in the proposed new business opportunity rule advanced by the FTC in 2006.[15]

3. *Exemptions*

The FTC Rule, like many state franchise laws, contains a number of exemptions. The most important are for "fractional franchises" (where any of the franchisee's directors or officers has more than two years of experience in the same type of business and there is a reasonable basis to anticipate that sales from the relationship will not exceed 20% of the franchisee's total dollar volume in sales during the first year), for departments of department stores, for employer-employee relationships,[16] and for purely

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13 *See, e.g.*, Minn. Stat. Section 80C.01(9).

14 FTC Interpretive Guides to Franchising and Business Opportunity Ventures Trade Regulation Rule Section I.A.1.c., 44 Fed. Reg. 49,966 (1979) (July 25, 1979) (*reprinted in* BUS. FRAN. GUIDE (CCH) ¶ 6207). *See also Wright-Moore Corp. v. Ricoh Corp.*, 908 F.2d 128, 135-36 (7th Cir. 1990) and authorities cited therein (costs of required excess inventory and training costs can constitute franchise fee under Indiana statute); *cf. To-Am Equipment Corp. Inc. v. Mitsubishi Caterpillar Forklift America, Inc.*, 953 F. Supp 987 (N.D. Ill. 1997), *aff'd*, 152 F.3d 658 (7th Cir. 1998) (questioning whether fees for parts and repair manuals could satisfy fee element). *But see Bryant Corp. v. Outboard Marine Corp.*, 1994 WL 745159, BUS. FRAN. GUIDE (CCH) ¶ 10,604) (W.D. Wash. 1994) (payment by distributor of taxes imposed on supplier and payment to supplier for training services did not constitute franchise fees under Washington statute).

15 See footnote 9 above.

16 One of the advantages of being a franchisor is that the business and brand name can be expanded into other regions and states without the franchisor bearing overhead costs of opening each store and the burdens of hiring employees that are entitled to protection under state and federal employment and anti-discrimination laws. However, some courts have expanded the definition of who is an employer, and franchisors have to worry about being added to that growing list of unintended employers. In *Awuah v. Coverall North America, Inc.*, 707 F.Supp.2d 80 (2010) (D. Mass. 2010), for example, a federal court ruled that the franchisor was unable to establish the elements of the Massachusetts' Independent Contractor Act, which provides that a person is an independent contractor if (i) the contractor is free from control and direction in connection with the performance of a service, (ii) the contractor performs a service that is outside the usual course of the

oral arrangements.[17] This last exemption is smaller than it appears – an invoice might qualify as the necessary writing. The amended Rule also contains a "sophisticated investor" exemption for transactions involving an investment of at least $1,084,900, sales to entities with a net worth of at least $5,424,500 that have been in the business involved for at least five years, and sales to executives of the franchisor.[18] In an effort to promote uniformity, the North American Securities Administrators Association in 2011 proposed for comment model language for states to use in promulgating exemptions in four areas: fractional franchises, experienced franchisors, sophisticated purchasers, and a discretionary exemption.

4. *Disclosure Requirements*

What are the consequences for a supplier if his distribution arrangements fall within the FTC Rule?[19] The principal one is that a very extensive disclosure document must be

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employer's business and (iii) the contractor is customarily engaged in an independently established trade or profession. The court rejected the franchisor's claim that franchisee was an independent contractor by focusing on the second prong of the test and finding that franchising is not a "business" in itself. The court held that because the franchisor maintained tight control of the franchisee's operations, including detailed cleaning standards and the exclusive right to perform all billing, the franchisor and franchisee were operating the same business. (*But see Jan-Pro Franchising International, Inc. v. Depianti*, No. A11A0342 (Ct.App.Ga. June 23, 2011) (reaching opposite conclusion under Massachusetts law in case of franchisor which licensed master franchisees who actually entered into franchise agreements).) In contrast, in *Doctors' Associates, Inc. v. Uninsured Employers' Fund*, Case No. 2010-SC-000568-WC (Sup.Ct.Ky. Nov. 23, 2011), the Supreme Court of Kentucky held that a franchisor could not be held liable for worker compensation claims of a franchisee employee where the franchisee lacked workers' compensation insurance. The Court held that most of the franchisor's business was "to act as a franchisor who licensed others to operate Subway stores." It found the franchisor-franchisee relationship thus was not a contractor-subcontractor relationship that would trigger "up-the-ladder employer" liability under Kentucky law, noting that the franchisee paid a fee to the franchisor, unlike a subcontractor who was paid by the contractor. Although the trial court in *Awuah* subsequently dismissed the allegations that the plaintiff should have been classified as an employee because the franchisee failed to show damages from the claimed misclassification, these two cases, taken together, indicate that franchisors need to be familiar with the employer-employee relationship laws of the states in which they operate to avoid being deemed employers.

17 16 C.F.R. § 436.8

18 16 C.F.R. §§ 436.8(a)(5) and (6).

19 The FTC enforces the Rule actively, suing franchisors who fail to comply with the Rule and obtaining injunctive relief and substantial penalties. As of June 2002, the FTC had brought over 200 law enforcement actions under the Rule and Section 5 of the FTC Act against franchisors and business opportunity ventures, involving over 640 entities and individuals. Prepared Statement of the Federal Trade Commission on "The Franchise Rule" before the Subcommittee on Commerce, Trade and Consumer Protection, Washington, D.C. (June 25, 2002). *See, e.g., U.S. v. Ferrara*, 334 F.3d 774 (8th Cir. 2003), cert. denied, 540 U.S. 1139 (Jan. 12, 2004) (affirming a sentence of over ten years in prison and $102,674.90 in restitution after defendant pled guilty to contempt of court for violating a consent judgment requiring defendant to comply with the disclosure requirements of the Rule); *FTC v. The Car Wash Guys* Int'l, BUS. FRAN. GUIDE (CCH) ¶ 11,921 (C.D. Cal. 2000) (FTC filed a temporary restraining order against corporate and individual defendants and froze their assets based on allegations the defendants had failed to provide documentation supporting their earnings and made false representations); FTC *v. Tashman*, BUS. FRAN. GUIDE (CCH) ¶ 11,919 (S.D. Fla. 2000) (under a settlement with the FTC, which had charged defendants with failing to give prospective purchasers complete and accurate disclosure documents, one defendant was permanently enjoined from engaging in the sale of business opportunities and a second defendant was required to post a $75,000 bond before engaging in the sale or marketing of any business opportunity and both were barred from transferring or selling their customer lists). In one case a franchise promoter was sentenced to three years in prison and ordered to pay restitution of $80,500 after pleading guilty to criminal charges brought for criminal conspiracy to violate the Rule. The promoter had violated a temporary restraining order in a prior civil action by

provided to prospective distributor-franchisees at the first personal meeting or ten business days before any contract is signed or payment made.[20] Among the information that must be provided are the franchisor's audited financial statements, information about the franchisor's history, including litigation and bankruptcy history and operating experience, a description of the franchisor's termination rights, and restrictions on the business that the franchisee may conduct. There are also very specific restrictions on earnings claims or projections – including a requirement that there be a reasonable basis for all claims, an explicit statement of all assumptions, and a report of the franchisees who have done as well in the same market. As a result of these restrictions, such claims or projections are generally not made. The states with franchise disclosure laws generally require similar documents not only to be provided to prospective franchisees, but also to be filed with, and often approved by, state authorities.[21] The burden of compliance with differing state requirements was eased to some extent by the acceptability in virtually all states and by the FTC of the Uniform Franchise Offering Circular ("UFOC"), although minor modifications to the UFOC form were required by several states.[22] The UFOC has been replaced by the 2008 Registration and Disclosure Guidelines (amended and restated UFOC Guidelines), which virtually all of the states are expected to eventually accept, albeit in some cases with individual state modifications. Eleven states[23] have recently moved towards simplifying the registration process for initial registrations. By completing an Application for Coordinated Review of Franchise Registration (Form CR-FRAN)[24], a franchisor may address the issues of all states it is filing in with a single comprehensive comment letter. This is not to minimize the burden of compliance, however. The information required to be compiled and presented in a

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continuing to sell franchises without proper disclosure. He remained liable for $1.4 million in consumer redress and $870,000 in civil penalties assessed in the prior action. *Jaspon,* TRADE CAS. (CCH) ¶ 22,943 (1991) (sentencing in connection with Mr. Tuff Tire franchises). In an innovative enforcement move, a court order allowed the FTC to assume control of a World Wide Web page operated by defendants and arranged for consumers who accessed the page to be linked automatically to information about the FTC's complaint of FTC Rule violations and earnings misrepresentations. *FTC v. Chappie*, BUS. FRAN. GUIDE (CCH) ¶ 10,960 (S.D. Fla. 1996).

20 The amended Franchise Rule replaces these timing requirements with a requirement that disclosure be made fourteen calendar days before any franchise agreement is signed or money is paid. 16 C.F.R. § 436.2(a). The amended Franchise Rule also permits electronic delivery of the disclosure document, with the franchisee's consent. 16 C.F.R. § 436.3(f).

21 California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin currently require registration of disclosure documents with state authorities before sales are made in that state.

22 The burden of compliance on a franchisor offering franchises on a multistate basis has been considered in several arenas. A proposed Uniform Franchise and Business Opportunity Act was approved by the American Bar Association in February 1988, but opposed by the North American Securities Administrators Association ("NASAA") in October 1988. BUS. FRAN. GUIDE (CCH) ¶¶ 3600, 9242. In August 1990 the NASAA adopted its own proposed Model Franchise Investment Act. BUS. FRAN. GUIDE (CCH) ¶ 3700; No. 128 Part II (Sept. 28, 1990), calling for registration with state agency review and disclosure requirements. (Restrictions on termination and non-renewal, included in the original NASAA draft, were dropped in the version finally adopted.)

23 New York, Hawaii, North Dakota, Illinois, South Dakota, Indiana, Rhode Island, Maryland, Virginia, Minnesota and Washington.

24 Form CR-FRAN can be found at BUS. FRAN. GUIDE (CCH) ¶5860.

narrowly defined format is quite detailed.[25] It is not something a supplier generally wants to do if it is not required.

C. *State Laws*

Well over thirty states currently have laws regulating general business franchises or business opportunities in some fashion.[26] In addition, many states have laws regulating distributorships in specific industries.[27] This is not an exclusively domestic phenomenon. In recent years many countries have instituted laws and regulations governing franchise relationships.[28]

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25 *See The Uniform Franchise Offering Circular Guidelines*, adopted by NASAA on April 25, 1993, *reprinted in* CCH BUS. FRAN. GUIDE, Extra Edition No. 161 (May 25, 1993), amended and restated as of June 6, 2008, by the *2008 Franchise Registration and Disclosure Guidelines (amended and restated UFOC Guidelines)* (the "Guidelines"), *available at* http://www.nasaa.org/content/files/2008ufoc.pdf. Among the more significant UFOC requirements are: (i) obligations of the franchisee and terms of renewal, termination, transfer and dispute resolution must be disclosed in summary tabular form by specified categories with cross-references to the franchise agreement (items 9 and 17); (ii) all affiliates of the franchisor must be disclosed, and the obligations to disclose litigation and bankruptcy history applies to affiliates as well as to the franchisor (items 1, 3 and 4); (iii) all regulations specific to the industry involved must be disclosed (item 1); (iv) the disclosure of litigation includes material settlements entered into after commencing franchise sales, with no exception for those subject to confidentiality orders (item 3); (v) disclosure of fees, initial investment and restrictions on sources of products and services must "provide reasonably available information to allow franchisees to forecast future changes listed in these Items and to be paid to persons who are independent of the franchisor." (items 5-8, § 160); (vi) disclosure of the franchisor's obligations is limited to obligations that are required by the franchise agreement and may not include assistance offered by the franchisor but not contractually mandated (item 11); (vii) disclosure of advertising programs is to include the media in which advertising may be disseminated, whether the coverage is local, regional or national, the creative source of the advertising and the details of any advertising councils, cooperatives and funds (item 11); (viii) disclosure of the franchisee's territory must include any restrictions on franchisor-owned or additional franchise outlets in the territory, and on the solicitation of orders by the franchisor, affiliates or other franchisees within the territory, whether under the same or different trademarks (item 12); (ix) the franchisor must provide the name, address and telephone number of every franchisee that was terminated, not renewed or otherwise stopped doing business during the last complete fiscal year, or who has not communicated with the franchisor within the prior ten weeks, as well as numeric data concerning transfers, terminations, nonrenewals and the like during the last three fiscal years (item 20); (x) any choice of law, choice of forum or arbitration provisions must be prominently disclosed on the cover page. The UFOC form imposes a "plain English" requirement that forbids the use of many specific "legal antiques and repetitive phrases."

26 A table listing these laws appears in the appendix to this article. The table should not be relied upon in making decisions — not only is this a rapidly changing area, but in every case it is important to go to the full statute and any regulations or interpretive guides.

27 Industries subject to industry-specific state franchise laws include farm equipment, alcoholic beverages, petroleum products and motor vehicles. The latter two industries are governed by federal dealer protection statutes as well.

28 An overview of international franchise laws and regulations appears in the BUSINESS FRANCHISE GUIDE (CCH) as follows: Australia ¶ 7000, Brazil ¶ 7010, Canada ¶ 7020, China ¶ 7060, European Union ¶ 7100, France ¶ 7130, Indonesia ¶ 7140, Italy ¶ 7150, Korea ¶ 7160, Malaysia ¶ 7180, Mexico ¶ 7200, Romania ¶ 7220, Russia ¶ 7230, and Spain ¶ 7250.

1. *Franchise Definitions*[29]

As with the FTC Rule, the various state law definitions of "franchise" usually include a trademark element (either substantial association with the supplier's mark or a license to use it) and a marketing element (either a marketing plan prescribed in substantial part by the supplier or a "community of interest" between supplier and distributor in the marketing of the product). Often – but *not* always – there is also a franchise fee element, with a range of minimum amounts.[30] In some states, including Mississippi, Nebraska, New Jersey and Virginia, the state franchise laws apply only if there is a written agreement. Most states also provide a variety of exemptions, common ones being for fractional franchises and for suppliers with a large net worth. In addition, some courts have held various state franchise laws not to apply to multi-line distributorships which are not dependent for their business on a single manufacturer.[31]

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29 In addition to laws regulating franchises, a number of states have "business opportunity" laws which require disclosure and sometimes registration, but generally do not regulate termination or other substantive aspects of the relationship. These typically apply where a purchaser buys or leases products, equipment, supplies or services to start a business and one of four representations is made:

(i) The seller will help find locations for vending machines or rack displays;

(ii) The seller will purchase everything the buyer makes using the seller's supplies;

(iii) The seller guarantees the purchaser will derive income exceeding the price paid or the seller will return the purchase price or buy back any remaining products, equipment or supplies; or

(iv) The seller will provide, on payment of some minimum amount, a sales or marketing program which will enable the buyer to derive income from the business opportunity.

See, e.g., Calif. Civil Code § 1812.201; Florida Statutes, 1981, § 559.801. Avoiding these representations, and thereby the statutory disclosure and registration requirements, may not be so simple. Note the similarity of the last two representations. A Connecticut advisory interpretation of its business opportunity law found the difference to be that a guarantee of income exceeding the price paid must be explicit, but that nobody would pay for a marketing plan unless he expected a profit, that therefore the representation that such deals would enable the buyer to derive income would be inferred, and that any disclaimer would be "frowned on." *See* Connecticut Banking Commissioner's Office Advisory Interpretation (August 24, 1981), *reprinted in* BUS. FRAN. GUIDE (CCH) ¶ 7699.

It is also worth noting that some 25 states have laws regulating commission sales representatives, typically requiring written agreements setting forth how commissions are calculated and requiring payment within a specified period after termination. Some laws provide for double or treble damages. A few, such as Puerto Rico and Minnesota, restrict a supplier's right to terminate a sales representative without statutory "good" or "just" cause. P.R. Act. No. 21 of December 5, 1990; Minn. Stat. § 325E.37. A list of such state laws appears at BUS. FRAN. GUIDE (CCH) ¶ 2022. As noted above, sales representatives may also be protected by franchise laws in certain circumstances. See fn 5 and accompanying text, above.

30 The California and Hawaii franchise definitions are typical:

"'Franchise' means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

(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; and

(2) The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and

(3) The franchisee is required to pay, directly or indirectly, a franchise fee."

California Corporations Code section 31005(a).

"'Franchise' means an oral or written contract or agreement, either expressed or implied, in which a person grants to another person, a license to use a trade name, service mark, trademark, logotype, or related characteristic in which there is a community interest in the business of offering, selling, or distributing goods or services at wholesale or retail, leasing, or otherwise, and in which the franchisee is required to pay, directly or indirectly, a franchise fee."

Hawaii Revised Statutes, Title 26, Chapter 482E-2.

31 *See, e.g., Grand Light & Supply Co., Inc. v. Honeywell, Inc.*, 771 F.2d 672 (2d Cir. 1985) (Connecticut

This decision, if adopted by courts in other states, could pave the way for a reduced impact of franchise laws on many distribution systems.

It thus is important to check the statutes and case law of every potentially relevant state, including every state in which distributors or licensees are located or operate, as well as those in which the supplier does business. New York's franchise law, for example, applies not only to franchises located in the state, but also to offers originating or accepted in New York,[32] and Washington's law has been held by one 9th Circuit panel to apply to out-of-state franchisees of Washington franchisors.[33] In order to determine if a distributorship is situated in Wisconsin for purposes of the Wisconsin Fair Dealership Law, the Wisconsin Supreme Court has recently implemented a balancing of factors test as opposed to the considering the location of the manufacturer or the presence of a Wisconsin forum selection clause.[34]

2. *Penalties*

Failure to comply with the registration and disclosure laws often constitutes a criminal offense. Civil penalties are often available in actions by the state attorney general. In addition, while no private right of action is available under the FTC Rule,[35] state laws generally give the franchisee a right of rescission and a claim for damages, not only against a franchisor that fails to comply, but against its parent, and its officers, directors and employees in their individual capacities.[36] Finally, a federal court in New

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law; court looked past literal language of statute to avoid "absurd" result); *New Jersey American, Inc. v. Allied Corp.*, 875 F.2d 58 (3d Cir. 1989) (N.J. law; multi-line distributor with 38% of sales from supplier not a franchisee); *C.L. Thompson Co., Inc. v. Festo Corp.*, 708 F. Supp. 221 (E.D. Wis. 1989) (Wis. law; multi-line distributor with 15% of sales from supplier not a "dealer" under Wis. statute); *but see Reinders Bros. v. Rain Bird Eastern Sales Corp.*, 627 F.2d 44 (7th Cir. 1980) (applying Wisconsin franchise law to dealer who purchased only 4% of its total sales from defendant).

32 N.Y. Gen. Bus. Law § 681 subd.12.

33 *Red Lion Hotels Franchising v. MAK, LLC*, 2011 WL 6061516 (9th Cir. Dec. 7, 2011). *But see Taylor v. 1-800-GOT-JUNK?, LLC*, No. 09-35661 (9th Cir. July 14, 2010) (not for publication), in which another panel of the 9th Circuit held Washington's Franchise Investment Protection Act did not protect out-of-state franchisees.

34 *See Baldewein Co. v. Tri-Clover, Inc.* 606 N.W.2d 145 (Wisc. Sup. Ct. 2000) (the court considered the following factors: (1) percentage of dealers' sales in Wisconsin; (2) the duration of the relationship; (3) the extent and nature of obligations regarding operations in Wisconsin; (4) the nature of the territory in Wisconsin; (5) the extent of the use of the manufacturer's mark; (6) the extent and nature of dealers' investment in business in the state; (7) personnel devoted to the Wisconsin market; (8) the level of advertising or promotion expenditures in Wisconsin; and (9) the extent and nature of supplemented services provided in Wisconsin.)

35 Note, however, that one court has held that, in a franchisee's suit for fraud, the FTC Rule sets the standard by which a franchisee's duty to disclose is determined, thus apparently creating an indirect private right of action where no direct one exists. *Rodopoulos v. Sam Piki Enterprises, Inc.*, 570 So.2d 661 (Ala. Sup. Ct. 1990).

36 *See, e.g.*, N.Y. Gen. Bus. Law § 691; Calif. Corp. Code §§ 31300 *et seq*; *A.J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc.*, 87 N.Y.2d 574, 640 N.Y.S.2d 849 (1996) (officers, directors and employees of franchisor are liable for franchisor's violation of franchise law if they materially aid in violation). Jurisdiction may constitutionally be found over those individuals in the franchisee's home state even if they never set foot there. *Retail Software Services, Inc. v. Lashlee*, 854 F.2d 18 (2d Cir. 1988). While no private right of action exists under the FTC Rule, the proposed federal legislation described at note 15 above would allow private actions for damages and equitable relief, as well as attorneys' fees.

York has held that a franchisor that fails to register in compliance with the New York Franchise Sales Act cannot enforce its franchise agreements in that state.[37] However, this ruling was recently rejected by a New York state court, which held that the covenants not to compete contained in a franchise agreement could be enforced against a former franchisee despite the franchisor's failure to register in New York.[38]

3. *Restrictions on Termination*

In addition to the laws requiring disclosure and registration in connection with the sale of franchises, a number of states – some with and some without disclosure requirements – impose severe restrictions on the franchisor's right to terminate a franchise relationship and otherwise regulate the substantive aspects of the relationship, such as restricting a supplier's right to refuse a franchisee's transfer of his franchise; restricting the establishment of new outlets near existing franchises; limiting restrictions on competition by franchisees; and regulating requirements respecting the source of goods and services used in the operation of the franchise.[39] Some states, such as Mississippi, merely require a minimum notice period for termination. Most, however, also require "good cause" or "just cause" and an opportunity to cure[40] before a supplier may terminate a distribution relationship which falls within the state's definition of a franchise, or even may fail to renew such a relationship upon expiration of a contract.[41]

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37 *King Computer Co. Inc. v. Beeper Plus Inc.*, 1993 U.S. Dist. LEXIS 2707, BUS. FRAN. GUIDE (CCH) ¶ 10,182 (S.D.N.Y. 1993).

38 *TKO Fleet Enterprises, Inc. v. Elite Limousine Plus, Inc.*, 708 N.Y.S.2d 593 (Sup. Ct. Qns. Co., 2000).

39 *See, e.g.*, Iowa Code §§ 523H.1 to .17, which bars franchisors from requiring franchisees to purchase goods and supplies from the franchisor or designated sources when comparable goods and supplies can be bought from other sources. There are also laws regulating termination in specific industries, such as petroleum products, motor vehicles, farm equipment, beer, wine and liquor and office equipment. Petroleum products and automobile dealers are also protected by federal statutes. 15 U.S.C. §§ 1221 et seq. (automobile dealers); 5 U.S.C. §§ 2801 *et seq*. (motor fuel). Such substantive restrictions have generally withstood constitutional attacks, although one court has held such restrictions in a farm equipment dealer protection law violative of a state constitution's due process clause. *Mays v. Massey-Ferguson, Inc.*, 1990 U.S. Dist. LEXIS 10245, 1990 WL 80673, 1990-1 TRADE CAS. (CCH) ¶ 69,028, BUS. FRAN. GUIDE (CCH) ¶ 9617 (S.D. Ga. 1990) at pp. 21,268-70 (holding that restrictions on termination and other provisions of farm equipment dealer law violate Georgia Due Process Clause by restricting freedom of contract in industry not affected with public interest). That decision has since been reversed by constitutional amendment, Ga. Laws of 1992, Resolution Act 125, approved May 6, 1992, ratified November 3, 1992, and the statute was reenacted.

40 The opportunity to cure may be required even for material, willful breaches of the franchise agreement. *See Malek v. Southland Corp.*, BUS. FRAN. GUIDE (CCH) ¶ 11,386 (W.D. Wash. 1998) (franchisee who misappropriated money orders was entitled to opportunity to cure under Washington franchise law).

41 The Third Circuit has reversed a lower court holding that such restrictions violate the Commerce Clause as applied to the termination of portions of a franchisee's exclusive territory which are outside the state whose law would otherwise bar termination. *Instructional Systems, Inc. v. Computer Curriculum Corp.*, 35 F.3d. 813 (3d. Cir. 1994), *cert. denied*, 573 U.S. 1133, 115 S. Ct. 1176 (1995) (reversing 826 F. Supp. 831 (D.N.J. 1993)). The proposed Small Business Franchise Act of 1999 would bar termination without good cause and an opportunity to cure, prohibit post-term non-compete clauses, restrict the right to require the purchase of equipment and supplies from the franchisor, limit a franchisor's ability to withhold consent to franchise transfers, and impose a duty of due care and, in some circumstances, a fiduciary duty, on franchisors. H.R. 3308.

Moreover, statutory restrictions on termination may apply even to territories beyond the jurisdiction, if the distributor has substantial connections to the jurisdiction. A federal court applied Puerto Rico's strict dealer protection statute to the termination of distribution rights in the Dominican Republic, where the distributor was based in Puerto Rico and performed much of its distribution activities there.[42]

Puerto Rico's Law 75, the Dealer's Contracts Act, applies broadly to virtually all distribution relationships where a dealer has "effectively in his charge in Puerto Rico the distribution, agency, concession or representation of a given merchandise or service."[43] Moreover, the Dealer's Contracts Act has been held to apply to protect both Puerto Rico-based distributors who distribute elsewhere,[44] and non-Puerto Rico-based distributors who distribute in Puerto Rico[45]

a. *"Good Cause"*

Statutory good cause may be very narrowly defined.[46] Usually, poor sales performance alone will not suffice.[47] Often, however, a franchisee's failure to comply with reasonable provisions of a franchise agreement *will* constitute good cause, and sales quotas or performance standards may qualify as a reasonable requirement of the franchise agreement.[48] From a supplier's point of view, therefore, the inclusion of sales quotas or other performance standards may be crucial if termination of an unsatisfactory

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42 *Beatty Caribbean, Inc. v. Viskage Sales Corp.*, 241 F. Supp. 2d 123 (D.P.R. 2003).

43 10 Laws of P.R. § 278.

44 *Beatty Caribbean*, *supra* n. 40.

45 *See, e.g., A.M. Capen's Co., Inc. v. American Trading Corp*., 74 F.3d 317 (1st Cir. 1996) (Puerto Rico Dealer's Contracts Act applies to distributor with exclusive right to distribute supplier's product in Puerto Rico, even though neither supplier nor distributor was located in Puerto Rico, and contract was negotiated and executed in continental U.S.).

46 Minnesota's definition of "good cause" is a good example of the limited grounds explicitly set forth:

> "'Good cause' means failure by the franchisee to substantially comply with the material and reasonable franchise requirements imposed by the franchisor including, but not limited to:
>
> (1) The bankruptcy or insolvency of the franchisee;
>
> (2) Assignment for the benefit of creditors or similar disposition of the assets of the franchise business;
>
> (3) Voluntary abandonment of the franchise business;
>
> (4) Conviction or a plea of guilty or no contest to a charge of violating any law relating to the franchise business; or
>
> (5) Any act by or conduct of the franchisee which materially impairs the goodwill associated with the franchisor's trademark, trade name, service mark, logotype or other commercial symbol."

Minnesota Statutes, § 80C.14(b).

47 *But see R.W. Int'l Corp. v. Welch Foods, Inc.*, 88 F.3d 49, 52-54 (1st Cir. 1996) (*bona fide* good faith impasse in contract negotiations could constitute just cause under Puerto Rico Dealers' Contracts Act); *Petereit v. S.B. Thomas, Inc.*, 63 F.3d 1169, 1184 (2d Cir. 1995) (supplier's legitimate business reasons, here its determination that it could increase sales by distributor realignment, constituted good cause for termination under Connecticut Franchise Act).

48 If there is any doubt as to the applicability of a franchise law, *sales* standards are generally preferable to purchase requirements. If a distributor is required to buy more than he can reasonably resell, the requirement might be considered a franchise fee, thereby bringing the relationship within a state law or the FTC Rule.

wholesaler is to be possible down the road. A supplier about to enter a relationship that might constitute a franchise thus should analyze carefully exactly what it expects from its distributors and define clear – and, where possible, quantifiable – standards which, if not met, will provide contractual grounds for termination.

This point was recently driven home when a distributor, attempting to terminate its relationship with a manufacturer, argued that because the contract was of indefinite duration it was terminable at will. The California Appellate Court however, ruled that the contract was enforceable to the extent it stated that it continued so long as each party performed its obligations.[49]

Other grounds that may constitute the requisite good cause, depending upon the state involved, are bankruptcy or insolvency,[50] voluntary abandonment (which seems more like termination by the *franchisee*), conviction of a crime relating to the conduct of the franchise business or, in some states, actions impairing the franchisor's good will. But a good faith business reason for a decision to terminate generally is not enough.[51] Indeed, there are some cases holding that even a supplier's decision to withdraw entirely from doing business in a state or other geographical market was not good cause and that a distributor terminated as a result of that decision could recover damages.[52] On the other hand, the Wisconsin Supreme Court has held that a distributor's

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49 *Zee Medical Distributor Association, Inc. v. Zee Medical, Inc.*, 80 Cal. App. 4th 1, 94 Cal. Rptr. 2d 829 (Cal. App. 2000).

50 The federal bankruptcy code, however, precludes enforcement of a termination provision which simply allows or requires termination upon bankruptcy. 11 U.S.C.A. § 365(e)(1)(A). A better approach is to provide for a right to terminate upon the distributor's net worth becoming negative or its becoming unable to pay its debts as they come due. To be effective, of course, this requires the supplier to monitor the financial condition of its distributors and to give notice of termination if trouble looms.

51 *See, e.g., Wright-Moore Corp. v. Ricoh Corp.*, 908 F.2d 128 (7th Cir. 1990) (franchisor's own economic reasons for termination do not constitute good cause under Indiana franchise law). *But see Morley-Murphy Co. v. Zenith Electronics Corp.*, 142 F. 3d 373 (7th Cir. 1998) (supplier's economic circumstances may constitute good cause for termination under Wisconsin Fair Dealership Law, provided termination is a proportionate response to an objectively ascertainable need and is non-discriminatory); *American Mart Corp. v. Joseph E. Seagram & Sons, Inc.*, 824 F.2d 733, 734 (9th Cir. 1987) (supplier's new national marketing plan justified termination of Nevada franchises).

52 *See, e.g., General Motors Corp. v. Gallo GMC Truck Sales, Inc.*, 711 F. Supp. 810 (D.N.J. 1989); *Westfield Centre Service, Inc. v. Cities Service Oil Co.*, 86 N.J. 453, 432 A.2d 48 (1981); *see also Kealey Pharmacy & Home Care Service, Inc. v. Walgreen Co.*, 539 F. Supp. 1357 (W.D. Wis. 1982), 607 F. Supp. 155 (1984), *aff'd*, 761 F.2d 345 (7th Cir. 1985); (supplier which changed distribution system to cease using independent dealers and instead rely solely on company-owned stores was liable in damages under Wisconsin Fair Dealership Law). The availability of injunctive relief, as opposed to damages, in a situation where the supplier is withdrawing from the market, is more problematic. While no court has held that such an injunction would be unconstitutional, several have suggested that it would raise serious constitutional questions. *See, e.g., St. Joseph Equipment v. Massey-Ferguson, Inc.*, 546 F. Supp. 1245 (W.D. Wis. 1982); *Westfield Centre Service, Inc. v. Cities Service Oil Co., supra*. Moreover, there are cases in which market withdrawal was deemed to be good cause. *Borg-Warner Int'l Corp. v. Quasar Corp.*, 138 P.R. Dec. 60 (P.R. Sup. Ct. 1995); *Medina & Medina v. Country Pride Foods, Ltd.*, 22 P.R. Office. Trans. 172 (P.R. Sup. Ct. 1989). This may be the case even where the "market withdrawal" is the result of the supplier's sale of the product line to a third party and the goods remain on the market through a new distributor, where there is no evidence of the supplier seeking to appropriate the goodwill and clientele developed by the distributor. *V. Suarez & Co., Inc. v. Dow Brands, Inc.*, 337 F. 3d 1 (1st Cir. 2003) (complete withdrawal from Puerto Rico market that is not arbitrary, on adequate notice, and not aimed at reaping dealer's goodwill or clientele, is just cause to terminate relationship under Puerto Rico Dealer's Act, Law 75).

refusal to accept essential and reasonable changes in the relationship with its supplier could qualify as "good cause" for termination where the changes were non-discriminatory and necessary to address economic problems of the supplier.[53]

Puerto Rico prohibits termination or non-renewal of a dealer's contract without "just cause," regardless of any contract provision permitting termination,[54] and limits just cause to "[n]onperformance of the essential obligations of the dealer's contract or any action or omission that adversely and substantially affects the interests of the principal … in promoting the marketing or distribution of the merchandise or service."

Suppliers should take care to comply exactly with statutory requirements for termination. A terminated New Hampshire beer distributor was awarded over $10 million in doubled damages for wrongful termination by a brewer, for failure of the brewer to make a formal legal demand for payment of overdue balances including an explanation of the consequences of nonpayment. The court also rejected the distributor's insolvency as a ground for termination, holding that balance-sheet insolvency, as opposed to an inability to pay debts as they came due, was required. Finally, the court held the termination to be in breach of the covenant of good faith and fair dealing.[55]

b. *Penalties*

The penalties for wrongful termination can be severe. In Puerto Rico (where the dealer protection law is especially broad and covers virtually all distribution arrangements[56]), the distributor can recover damages for everything he spent on the business that he cannot use for another purpose, the cost of his inventory, goodwill, plus, on top of all that, five years of profits.[57] In New Jersey, the wrongfully terminating supplier must compensate the distributor for the value of his business.[58] And, of course, in most states injunctive relief against the termination is generally available.

4. *Other Restrictions*

Other substantive statutory restrictions can include limitations on the addition of other franchisees in the same area, restrictions on discrimination among franchisees, limitations on price increases, requirements that franchisees be permitted to sell or assign

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53 *Ziegler Co., Inc. v. Rexnord, Inc.*, 147 Wisc. 2d 308, 433, N.W.2d 8 (1988). *See also East Bay Running Store, Inc. v. Nike, Inc.*, 890 F.2d 996 (7th Cir. 1989); *Moodie v. School Book Fairs, Inc.*, 889 F.2d 739 (7th Cir. 1989).

54 10 Laws of P.R. § 278a.

55 *Globe Distributors v. Adolph Coors Co.*, 129 B.R. 304 (Bankr. D.N.H. 1991).

56 *See, e.g., A.M. Capen's Co., Inc. v. American Trading Corp*., 74 F.3d 317 (1st Cir. 1996) (Puerto Rico Dealer's Act applies to distributor with exclusive right to distribute supplier's product in Puerto Rico, even though neither supplier nor distributor was located in Puerto Rico, and contract was negotiated and executed in continental U.S.).

57 10 Laws of Puerto Rico § 278b.

58 *Westfield Centre Service, Inc. v. Cities Service Oil Co., supra*. An interesting variation is the New Jersey liquor law, a violation of which is redressed by an order barring any wholesalers in the state from purchasing the offending supplier's products until sales to the complaining wholesaler are resumed. N.J. Rev. Stat. § 33:1-93.9.

their franchise rights, prohibitions on limiting the rights of franchisees to form associations and limitations on requiring that goods or services be purchased from the franchisor.[59] The statutes generally forbid any waiver by franchisees of their statutory rights.[60]

These restrictions, combined with existing contractual exclusivity provisions, can result in significant limitations on a franchisor's ability to take advantage of the Internet and expanding e-commerce opportunities. In a dramatic illustration, the American Arbitration Association held that the grant of an exclusive territory to a franchisee precludes Internet sales by the franchisor to customers within that territory.[61] Even if no such grant of an exclusive territory is made, some courts have determined that a franchisee nevertheless may expect that its franchise interest will not be impaired or destroyed by the franchisor.[62] Such an approach, combined with the restrictions in some statutes on the opening of additional franchise outlets in a franchisee's area[63] may result in handcuffing a franchisor's e-commerce plans. (In contrast, however, in another arbitration the panel came to a contrary conclusion, finding that H&R Block's offer of tax preparation services over the internet did not interfere with the franchisee's operation and did not violate the exclusive territory provisions or the franchise agreement.)[64]

Moreover, special industry laws may operate to preclude direct Internet sales by a franchisor entirely. In one recent case, a car manufacturer had operated an Internet site that allowed consumers to view pre-owned cars, which, once selected by the consumer, were shipped to a dealer with whom the final contract was made. A federal court held that under the Texas law that activity made the manufacturer a dealer, and held that such a dual role was unlawful.[65]

D. *Approaches to Dealing with Franchise Laws*

As a result of the substantive protections provided by state franchise laws and the valuable business information to be gained from their disclosure requirements, it is important for distributors and their counsel to be familiar with the statutes and regulations. Such familiarity not only allows the distributor to act on his legal rights, but also can enable him to structure a distribution arrangement that falls within the scope of coverage of the relevant state statute or the FTC Rule, thereby affording the distributor the protection of those laws.

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59 *See, e.g.*, Hawaii Rev. Stat. § 482E-6(2)(E); Indiana Code Tit. 23, art. 2, Ch. 2.7, § 1(2); 1981 Rev. Code Wash. § 19.100.180; N.J. Rev. Stat. § 56:10-7; Rev. Stat. Neb. § 87-406.

60 *See, e.g.*, Mich. Comp. Laws § 445.1527(d); Wis. Stat., Tit. XIV-A, § 135.025(3).

61 *Emporium Drug Mart, Inc. of Shreveport v. Drug Emporium, Inc.*, AAA, Dallas, Texas. Case No. 71 1140012600 (filed September 2, 2000), *reported at* BUS. FRAN. GUIDE. (CCH) ¶ 11,966.

62 *Foodmaker, Inc. v. Quershi*, BUS. FRAN. GUIDE (CCH) ¶11,780 (Cal. Sup. Ct. 1999).

63 *See, e.g.*, Hawaii Rev. Stat. § 482E-6(2)(E); Indiana Code Tit. 23, art. 2, Ch. 2.7, § 1(2)1981 Rev. Code Wash. § 19.100.180

64 *Matter of Franklin 1989 Revocable Family Trust and H&R Block, Inc.*, BUS. FRAN. GUIDE (CCH) ¶ 12, 473 (December 31, 2002).

65 *Ford Motor Co. v. Texas Dept. of Transportation*, 106 F. Supp. 2d 905 (W.D. Tex. 2000).

1. *Avoiding the Statutory Definitions*

By the same token, the burdensome and often time-consuming registration and disclosure requirements and the sometimes severe restrictions on the franchisor's ability to end an unsatisfactory relationship generally make it desirable for a supplier who does not need the various advantages of a franchise relationship[66] to avoid falling within franchise protection laws if at all possible. The first step is to see whether any of the statutory or regulatory exemptions, such as those for "fractional franchises" or suppliers with a statutory minimum net worth, may be satisfied. As always, both the FTC Rule and potentially applicable state law must be considered. If no statutory exemption is available, such suppliers and their counsel should seek to structure a distribution system which does not meet the basic definition of a franchise.

Usually, avoiding any of the three basic elements will do the trick, although not always. For example, in New York, only a fee plus either the trademark or the marketing element will constitute a franchise; in Arkansas, neither a fee nor a marketing element is necessary; in several other states a fee is not a necessary element; and in Puerto Rico, the statute is so broad as to cover almost any imaginable distribution relationship other than employer-employee.

a. *Avoiding the Trademark Element*

In some states, the trademark element can be avoided by limiting as far as practicable the distributor's right to use the supplier's marks. At a minimum, the distributor should not be allowed to do business under the supplier's name or trademark, as with the traditional fast food or similar "business format" franchises. In some states, however, the mere selling of trademarked goods may be enough to satisfy the trademark element. In California, for example, any display of the supplier's mark to the distributor's customers is sufficient.[67] In Indiana, a distributor's right to advertise itself as an "authorized distributor" for the brand was enough, even in the face of a prohibition on the use of the supplier's name and trademark.[68] In New Jersey, however, the statute applies only if the supplier's mark is included in the distributor's business name, or at least is used by the distributor "in such a manner as to create a reasonable belief on the

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66 *See generally* G. GLICKMAN, FRANCHISING § 14.05 (1983), regarding advantages and disadvantages. These advantages may include greater control over the distribution of a product and over quality standards, the generation of franchise fee income from sale of franchises even if sales of the actual product or service are slow to develop, the growth of the value of the supplier's trademark by identification of all distributors with the mark, the shifting from the supplier to the distributor of many start-up costs and, in certain cases, depending upon the results of an analysis of possible tie-in issues, the ability to control the sources from which the distributor may acquire the trademarked product or its components. *See, e.g.*, *Susser v. Carvel*, 206 F. Supp. 636 (S.D.N.Y. 1962), *aff'd*, 332 F.2d 505 (2d Cir. 1964) (right to require franchisees to purchase ice cream mix from certain suppliers).

The prospective franchisor must consider whether these advantages are outweighed by the detailed disclosure requirements, restrictions on termination, sharing of confidential business information and full licensing of trademarks that are likely to go along with a traditional franchise.

67 *See* State of California Guidelines for Determining Whether an Agreement Constitutes a "Franchise", *reprinted in* BUS. FRAN. GUIDE (CCH) ¶ 7558 at 12,350-51 (hereinafter cited as "California Guidelines"); Release No. 3-F Revised, June 27, 1994, *reprinted in* BUS. FRAN. GUIDE (CCH) ¶ 5050.45 at p. 7818; *see also Kim v. Servosnax, Inc.* 10 Cal. App. 4th 1346, 13 Cal. Rptr. 2d 422 (Cal. App. 1992) (cafeteria licensee barred from using licensor's trademark was nevertheless a franchisee because licensor communicated its name to host company that contracted with licensor for cafeteria services).

68 *Wright-Moore Corp. v. Ricoh Corp.*, 908 F.2d 128, 135 (7th Cir. 1990).

part of the consuming public that there is a connection between the . . . licensor and licensee by which the licensor vouches, as it were, for the activity of the licensee."[69] Again, it is important to check the law in each relevant state.

b. *Avoiding the Marketing Plan or Community of Interest Element*

If the trademark element cannot be avoided, the supplier may want to avoid requirements or even advice on how the distributor should run his business. In California, many factors could lead to a conclusion that the marketing plan element is present, such as advertising that a marketing plan is available (even if not required), providing exclusive territories, requiring supplier approval of sales locations, imposing rules governing uniforms, store layout or appearance, and using comprehensive promotional plans.[70] The FTC has held in an advisory opinion that promises of training, use of manuals and considerable operational assistance satisfied the FTC Rule's definitional element.[71] The cost of imposing such controls over distributors or providing such extensive assistance may be compliance with a franchise law.

In addition, if a franchisor has effective control over the operations of its franchisee, it may also find itself vicariously liable to third parties for the negligence or other misconduct of its franchisees.[72] Similarly, a franchisor may be liable for the conduct of a franchisee that is either required by the franchisor or represented as part of the

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69 *Instructional Systems, Inc. v. Computer Curriculum Corp.*, 130 N.J. 324, 352-53, 614 A.D.2d 124, 139 (N.J. 1992); *Finlay & Associates, Inc. v. Borg-Warner Corp.*, 146 N.J. Super. 210, 369 A.2d 541 (1976).

70 *See* California Guidelines, *supra*, at 12,348-49; Release No. 3-F Revised, June 27, 1984, *reprinted in* BUS. FRAN. GUIDE (CCH) ¶ 5050.45 at p.7816-18.

71 *Travelhost Magazine, Inc.*, BUS. FRAN. GUIDE (CCH) ¶ 6444 (March 2, 1989).

72 *See, e.g., Patterson v. Domino's Pizza LLC*, 207 Cal. App. 4th 385 (Cal.Ct.App. 2012), *review granted*, No. 5204543 (Cal.S.Ct. Oct. 11, 2012) (in sexual harassment claim, "franchisor may be subject to vicarious liability where it assumes substantial control over the franchisee's local operation, its management-employee relations or employee discipline"). *Kaplan v. Coldwell Banker Residential Affiliates, Inc.*, BUS. FRAN. GUIDE (CCH) ¶ 11,287 (Cal. Ct. app. 1997) (franchisor might be liable for franchisee's fraud and breach of fiduciary duty on ostensible agency theory, as a result of franchisor's advertising, use of logo and other communications that may lead public to believe they are dealing with agent for franchisor); *Miller v. McDonald's Corp*, 150 Ore. App. 274 (Ore. Ct. App. October 1, 1997) (franchisor's control over food handling and preparation could render it liable for customer's injury from biting into sapphire in hamburger; franchisee also may have been apparent agent of franchisor); *J.M. v. Shell Oil Co.*, 922 S.W.2D 759 (Mo. Sup. Ct. 1996) (franchisor's control over business operations of franchisee might be sufficient to hold franchisor liable in claim of plaintiff abducted from franchisee gas station); *see also United States v. Days Inns of America, Inc.*, 151 F.3d 827 (8th Cir.1998) (franchisor that failed to exercise its significant authority over design and construction of franchisee premises would be liable for franchisee's failure to comply with Americans with Disabilities Act if franchisor knew of the violation); *Naff v. American Dairy Queen Corp.*, 58 F.3d 1063, 1066 (5th Cir. 1995) (franchisor's liability for franchisee's failure to comply with requirements of ADA turned on whether franchisor controlled franchisee modification of premises); *but see Anderson v. Domino's Pizza, Inc*, No. 11-cv-902 RBL (D. Wash. May 15, 2012) (where franchisor provided software to make automated telephone calls through service introduced by franchisor and benefitted from automated calls that violated Washington prohibition on robo-calls, but where franchisor did not direct the calls, franchisor was not liable for violation of statute); *United States v. Days Inns of America, Inc.*, 22 F. Supp. 2d 612 (E.D. Ky. 1998) (franchisor did not own, lease or operate franchisee motel and so was not liable for ADA violations); *Masters v. Moreno Valley Travelodge*, (C.D. Cal. May 31, 1996), *reported in* 16 FRANCH. L.J. 90 (Fall 1996) (same). In 2012, the Federal Trade Commission asserted that a franchisor's control over franchisee information technology and data security made the franchisor responsible for franchisees' failure to implement adequate data security protections. *FTC v. Wyndham Worldwide Corp.* (D. Ariz.)(complaint filed June 26, 2012), *available at* www.ftc.gov/os/caselist/1023142/120626wyndhamhotelscmpt.pdf.

franchisor's operations.[73] However, a franchisor generally will not be held liable where the franchisor does not have control over the pertinent injury-causing day-to-day activities of the franchisee.[74]

In states with a "community of interest" standard rather than a marketing plan test, the supplier should seek to insure relative independence on the part of the distributor where possible.[75] For example, in appropriate circumstances, a supplier could insist that its products not constitute more than a specified percentage of the distributor's sales or profits or ensure that the distributor was not required to make any substantial investment which would become useless without the supplier's product line.[76]

c. *Avoiding the Franchise Fee Element*

Perhaps the easiest way to avoid a franchise definitional element exists in the states where a franchise fee is one of the elements. Generally, a bona fide wholesale price charged to a distributor will not constitute a franchise fee, nor will minimum inventory levels reasonably required by the business. But any money flowing from distributor to supplier is suspect and should be evaluated in light of the relevant statute, regulations and interpretive guides.[77]

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73 For example, in *Soto v. Superior Telecom, Inc.*, 2010 WL 2232145 (S.D. Cal. June 2, 2010), plaintiff brought suit against 7-Eleven and one of its franchisees for faulty phone cards purchased from the franchisee. The court found that 7-Eleven was liable since it required its franchisees to sell prepaid cards, devoted substantial time to marketing the cards and jointly shared the profits and losses of such cards with its franchisees. In *Bauer v. Douglas Aquatics, Inc., available at* Bus. Franchise Guide (CCH) ¶ 14,459 (N.C. Ct. App. Sept. 7, 2010), a North Carolina state court found that a pool construction franchisee acted as an agent of the franchisor, despite the fact that the agreement between them expressly provided that there was no agency relationship, and held that the franchisor was liable for damages since (i) the franchisor represented on its website that the franchisee was one of five locations, (ii) the franchisee represented itself as part of the franchisor and (iii) the contract between the parties identified the franchisor as the party responsible for the basic construction of the pool.

74 See, e.g., *Risner v. McDonald's Corp*., 18 S.W.3d 903 (Tex. App. 2000) (franchisor's liability for negligence at franchisee's location limited to instances where franchisor controls activity relating to negligence charge); *Castro v. Brown's Chicken and Pasta, Inc*., 732 N.E. 2d 37 (Ill. App. Ct. 2000) (franchisor not liable for security at franchisee location where 7 people were murdered because franchisor had not voluntarily undertaken to provide security for franchisee*); Wu v. Dunkin Donuts, Inc.*, 105 F. Supp. 2d 83 (E.D.N.Y. 2000) (franchisor not liable for rape of franchisee's employee where franchisee was responsible for day to day decisions regarding security and franchisor merely made suggestions), *aff'd* 2001 WL 170639, 4 Fed. Appx. 82 (2d Cir. 2001) (not selected for publication).

75 The Third Circuit recently held a "community of interest" not to exist unless there was such a degree of economic dependence on the franchisor "that it was subject to the whim, direction and control of a more powerful entity whose withdrawal from the relationship would shock a court's sense of equity." *New Jersey American, Inc. v. Allied Corp.*, 875 F.2d 58 (3d Cir. 1989) (quoting *Colt Industries Inc. v. Fidelco Pump & Compressor Corp.*, 844 F.2d 117 (3d Cir. 1988)). This construction seems narrower than most courts would adopt.

76 *See, e.g., Cassidy Podell Lynch, Inc. v. Snydergeneral Corp.*, 944 F.2d 1131 (3d Cir. 1991) (factors determining community of interest include licensor's control over licensee, licensee's economic dependence on licensor, disparity in bargaining power and presence of franchise-specific investment by licensee); *New Jersey American, Inc. v. Allied Corp.*, 875 F.2d 58 (3d Cir. 1989); *Ziegler Co., Inc. v. Rexnord, Inc.*, 139 Wis.2d 593, 407 N.W.2d 873 (1987); *Midwest Perishables, Inc. v. Jack Frost, Inc.*, BUS. FRAN. GUIDE (CCH) ¶ 9467 (W.D. Wis. 1989)

77 In one case, a federal court narrowly construed the franchise fee element of Minnesota's law, holding that minimum purchase requirements, mandatory advertising and training fees and a 50% surcharge on products sold at more than the supplier's suggested price did not constitute franchise fees. *See Brawley Distribution*

It is often possible to eliminate all such flows. Consignment sales, where the supplier pays a commission to the distributor and is paid for goods directly by the distributor's customers, are one such method.[78] A little imagination may lead to others. For example, a regional computer service bureau might use sales agents in its distribution system, perhaps providing the sales agents with software for their use in providing data processing services. The supplier wants to have the sales agents sell the services to customers and pay the supplier a 40% royalty. If, instead, the cash flow is reversed, so that the agent arranges the sale, but the supplier bills the customer and pays the agent a 60% commission, the substantive effect is the same, but there is no fee flowing from the agent to the supplier.

Another approach, at least with respect to the FTC Rule, is to avoid charging any fees or royalties for the first six months of the relationship, for the Rule exempts franchises in which payments made in that period are less than $500.[79] If state laws are applicable, however, these do not generally provide for such a limited period of concern.[80]

d. *Other Approaches*

Obviously, in states where the franchise law applies only to written agreements, it may be possible to avoid the statute by relying on an oral distributorship arrangement. The disadvantages of a purely oral agreement must be considered carefully, however. The potential is far greater for misunderstandings, disputes over what was agreed upon and claims by distributors that they were assured they would not be terminated if some low standard were met.

For suppliers based in states without restrictive franchise laws, an option is to provide for its home state's law to govern disputes, including termination disputes. Such choice of law provisions are often disregarded by courts in deference to the public policy of states with franchise laws.[81] Some courts in recent years, however, have honored the

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Co. v. Polaris Industries Partners L.P., BUS. FRAN. GUIDE (CCH) ¶ 9388 (D. Minn. 1989). In contrast, in *Flynn Beverage, Inc. v. Joseph E. Seagram & Sons, Inc.*, 815 F. Supp. 1174, 1179 (C.D. Ill. 1993), allegations of excessive inventory requirements were held a sufficient allegation of a franchise fee to survive a motion to dismiss. *See generally*, Release No. 3-F Revised, June 27, 1994, *reprinted in* BUS. FRAN. GUIDE (CCH) ¶ 5050.45 at p. 7818-21.

78 *See Gull Industries, Inc.* (FTC Advisory Opinion, October 5, 1983) (*reported in* 45 A.T.R.R. (BNA) 573 October 13, 1983).

79 *See* FTC Informal Staff Advisory Opinion 96-5 BUS. FRAN. GUIDE (CCH) ¶ 6480.

80 *Cf. To-Am Equipment Corp. Inc. v. Mitsubishi Caterpillar Forklift America, Inc.*, 953 F. Supp 987, (N.D. Ill. 1997) (questioning whether payment of $1,600 for parts and service manuals over eight year period could meet $500 franchise fee threshold under Illinois law).

81 *See, e.g., Gandolfo's Deli Boys, LLC v. Holman*, 490 F.Supp.2d 1353, (N.D. Ga. 2007) (choice of Utah law violated Georgia's public policy as to permissible scope of noncompetition clause, and would not be enforced); *Ticknor et al. v. Choice Hotels Int'l*, 265 F.3d 931 (9th Cir. 2001) (choice of Maryland law in a motel franchise agreement not enforced based on fact that only contact between franchisor and franchisee took place in Montana, the motel was operated in Montana and Maryland law would have violated Montana public policy); *Guild Wineries and Distilleries v. Whitehall Co., Ltd.*, 853 F.2d 755 (9th Cir. 1988) (giving preclusive effect to administrative ruling refusing to enforce choice of law provision); *Grand Kensington, LLC v. Burger King Corp*., 81 F. Supp. 2d 834 (E.D. Mich. 2000) (Florida choice of law provision in contract between Florida franchisor and Michigan franchisee unenforceable because it significantly eroded franchisee's protection under Michigan Franchise Investment Law); *Cottman Transmission Systems, LLC v. Kershner*, 492 F.Supp.2d 461, (E.D. Pa. 2007) (choice of Pennsylvania law unenforceable as violation of

parties' choice, at least in the absence of oppressive use of superior bargaining position, although the overall trend has been mixed.[82] In response to one such decision, Minnesota amended its franchise statute in May 1989 to invalidate any contractual choice of law clause.[83] It remains to be seen whether courts, particularly outside Minnesota, will give effect to this provision.

It is also noteworthy that at least one court, the First Circuit, has not only held that Maine's public policy expressed in its wine franchise law voided a contractual choice of

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public policy of California, New York and Wisconsin franchise disclosure laws, would erode quality of protection under those laws); *Caribbean Wholesales and Service Corp. v. US JVC Corp.*, 855 F. Supp. 627, 633 (S.D.N.Y. 1996) (application of contractual choice of New York law would violate public policy of Puerto Rico); *Winer Motors, Inc. v. Jaguar Rover Triumph, Inc.*, 208 N.J. Super. 666, 506 A.2d 817 (N.J. Super. 1986); *South Bend Consumer Club, Inc. v. United Consumers Club, Inc.*, 572 F. Supp. 209 (N.D. Ind. 1983); *R&R Associates of Connecticut, Inc. v. Deltona Corp.*, BUS. FRAN. GUIDE (CCH) ¶ 7526 (D. Conn. 1980); *Instructional Systems, Inc. v. Computer Curriculum Corp.*, 130 N.J. 324, 341-46, 614 A.D.2d 124, 133-35 (N.J. 1992) (choice of California law unenforceable as violating public policy of New Jersey Franchise Practices Act); *Dunes Hospitality, LLC v. Country Kitchen International, Inc.*, 623 N.W.2d 484 (S.D. Sup. Ct. 2001) (choice of Minnesota law disregarded because forum state public policy would be violated and most significant contacts occurred in forum state); *Covert Chevrolet-Oldsmobile, Inc. v. General Motors Corp.* No. 05-00-01170-CV, 2001 WL 950274 (Tex. App. Aug. 21, 2001) (not designated for publication) (Texas law applied to indemnification claim by dealer for costs of lawsuits against it brought in Texas by Texas residents despite choice of law provision selecting Michigan law; Texas had most significant relationship to dispute);*Ingmar GB Ltd. v. Eaton Leonard Technologies, Inc.*, Case C-381/98 (Times Law Report 16.11.00) (the European Court of Justice held that the English Commercial Agents Regulations must be applied where a commercial agent carried on his activities in a member state although the principal was based in a non-member state and the license agreement was governed by California law).

82 *See, e.g. JRT, Inc. v. TCBY Systems, Inc.*, 52 F.3d 734, (8th Cir. 1995) (enforcing choice of Arkansas law despite Michigan Franchise Investment Law antiwaiver provision because provision did not specifically address choice of law clauses); *Cherokee Pump & Equipment, Inc. v. Aurora Pump*, 38 F.3d 246 (5th Cir. 1994) (enforcing choice of Illinois law to permit termination of Louisiana distributorship in manner prohibited by Louisiana statute); *Modern Computer Systems, Inc. v. Modern Banking Systems, Inc.*, 871 F.2d 734 (8th Cir. 1989) (enforcing contractual choice of law clause); *Tele-Save Merchandising Co. v. Consumers Distributing Co.*, 814 F.2d 1120 (6th Cir 1987) (same); *Carousel Systems, Inc. v. Ordway*, 1996 WL 208359, BUS. FRAN. GUIDE (CCH) ¶ 10,914 (E.D. Pa. 1996); *Banek Inc. v. Yogurt Ventures, U.S.A., Inc.*, BUS. FRAN. GUIDE (CCH) ¶ 10,112 (E.D. Mich 1992) (enforcing contractual choice of law clause), *aff'd*, 6 F.3d 357 (6th Cir. 1993) (not designated for publication) (state franchise law antiwaiver provision did not preclude enforcing choice of law clause in absence of provision barring such clauses); *Cottman Transmission Systems, Inc. v. Melody*, 869 F. Supp. 1180, 1188 (E.D. Pa. 1994) (enforcing choice of Pennsylvania law, which does not cause substantial erosion of California statutory rights, to dismiss franchisee claims under California Franchise Investment Law); *Hardee's Food Systems, Inc. v. Bennett*, 1994 WL 1372628, BUS. FRAN. GUIDE (CCH) ¶ 10,453 (S.D. Fla. 1994) (enforcing contractual choice of N.C. law, rejecting claim under Fla. franchise statute); *Faltings v. Int'l Bus. Machines Corp.*, 854 F.2d 1316 (4th Cir. 1988) (not designated for publication) (enforcing contractual choice of law clause); *United Wholesale Liquor Co., v. Brown-Forman Distillers Corp.*, 108 N.M. 467, 775 P.2d 233 (N.M. 1989) (enforcing contractual choice of law clause); *Carlock v. Pillsbury Co.*, 719 F. Supp. 791 (D. Minn. 1989) (same); *but see Electrical and Magneto Service Co. v. AMBAC Int'l Corp.*, 941 F.2d 660 (8th Cir. 1991) (refusing to honor contractual choice of law clause); *Wright-Moore Corp. v. Ricoh Corp.*, 908 F.2d 128 (7th Cir. 1990) (same); *Caribbean Wholesales & Service Corp. v. US JVC Corp.*, 855 F. SUPP. 627 (S.D.N.Y. 1994) (same); *Flynn Beverage Inc. v. Joseph E. Seagram & Sons, Inc.*, 815 F. Supp. 1174 (C.D. Ill. 1993) (same); *Economou v. Physicians Weight Loss Centers of America*, 756 F. SUPP. 1024 (N.D. Ohio 1991) (same); *Scott v. Snelling and Snelling, Inc.*, 732 F. Supp. 1034 (N.D. Colo. 1990) (same); *cf. Pelican State Supply Co., Inc. v. Cushman, Inc.*, 39 F.3d 1184 (8th Cir. 1994) (unpublished opinion) (choice of Nebraska law did not make Nebraska state dealer law applicable to out-of-state dealer, where statute by its terms governed only dealers in Nebraska).

83 Minn. Stat. § 80C.21. *See also* S.D. Codified Laws § 37-5A-86; Ark. Laws of 1993, Act 310. The proposed federal franchise laws, see notes 15 and 27 above, would have barred any waiver of its provisions, as well as preclude mandatory arbitration provisions.

law provision, but went so far as to award sanctions against the supplier and its counsel for what it termed a "frivolous" appeal.[84]

The Eighth Circuit has held both ways, suggesting at one point that the determining factor may be whether the federal court faced with the question is being asked to apply the law of the forum state or of another forum.[85] This suggests that a race to the courthouse in the preferred forum may be worth the exercise.

The chosen law should have some relationship to the parties or the performance of the contract. A federal district court in New York has held invalid a choice of law provision which bore no reasonable relation to the parties or contract, applying New York law instead.[86] In selecting a particular state's law, note that this may result in the application of either a more or less restrictive state franchise law than might otherwise be the case.[87] Counsel for suppliers should consider seeking to carve such statutes out of the choice of law selection. While sometimes the statute itself may preclude an extraterritorial application,[88] it seems safer to provide explicitly that it does not apply.

In addition, care should be taken that references in the contract to the provisions of "applicable law" do not result in the application of a state franchise law notwithstanding the contrary choice of law. The Ninth Circuit held that a contract provision applying California law "[e]xcept as otherwise required by applicable law" did not preclude application of an Arizona franchise law, since that was the only other possible "applicable law".[89] Another trap for the unwary drafter was laid by the Ohio Court of Appeals which decided to enforce an arbitration clause in a contract with a severability clause that provided "any provision of this Agreement which in any way contravenes any

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84 *Solman Distributors, Inc. v. Brown-Forman Corp.*, 888 F.2d 170 (1st Cir. 1989).

85 *Electrical and Magneto Service Co., supra*, at 663-64 (distinguishing *Modern Computer Systems, supra*.

86 *La Guardia Associates v. Holiday Hospitality Franchising, Inc*., BUS. FRAN. GUIDE (CCH) ¶11,832 (D.C. N.Y. 2000) (Tennessee choice of law provision between New York franchisee and Georgia franchisor unenforceable for lack of rational relationship to state).

87 *Compare Faltings v. Int'l Bus. Machines Corp.*, 854 F. 2d 1316 (4th Cir. 1988) (not designated for publication) (choice of New York law precludes application of more restrictive New Jersey Franchise Practices Act); *Barnes v. Burger King Corp.*, 932 F. SUPP. 1441 (S.D. Fla. 1996) (California franchisee lacked standing to assert claim under Florida Franchise Act, despite contractual choice of Florida law); and *Edelen and Boyer Co. v. Kawasaki Loaders, Inc.*, 1992 WL 236909 BUS. FRAN. GUIDE (CCH) ¶ 10,171 (E.D. Pa. 1992) (Georgia heavy equipment dealer law not applicable to franchises outside Georgia, notwithstanding choice of Georgia law in franchise agreement); *with Tractor and Farm Supply, Inc. v. Ford New Holland, Inc.*, 898 F. Supp. 1198 (W.D. Ky. 1995); *Burger King Corp. v. Austin*, 805 F. Supp. 1007, 1022-23 (S.D.Fla. 1992) (allowing counterclaim by Georgia franchisees under Florida Franchise Act where franchise agreement chose Florida law); *McGowan v. Pillsbury Co.*, 723 F. Supp. 530 (W.D. Wash. 1989) (allowing claim that New York Franchise Sales Act was violated where agreement with Washington franchisee chose New York law); *and Dep't of Motor Vehicles v. Mercedes-Benz*, 408 So. 2d 627 (Fla. 1981), *modified*, 455 So.2d 404 (Fla. 1984) (applying New Jersey Franchise Practices Act to Florida franchise where contract chose New Jersey law).

88 *See Reface, Inc. v. Sears, Roebuck & Co.*, BUS. FRAN. GUIDE (CCH) ¶ 12,310 (E.D.Va. 2002) (Illinois Franchise Disclosure Act applies only to Illinois residents, not to non-residents that choose Illinois law to govern their contract); *Diesel Injection Service Co., Inc. v. Jacobs Vehicle Equipment Co.*, 2002 Conn. Super. LEXIS 1227, BUS. FRAN. GUIDE (CCH) ¶ 12,388 (Conn. Super. Ct. 2002) (Connecticut Franchise Act did not apply to parties choosing Connecticut law where distributor did not have place of business in state).

89 *Sutter Home Winery, Inc. v. Vintage Selections, Ltd.*, 971 F.2d 401, 406 (9th Cir. 1992).

law of any relevant jurisdiction shall be deemed not to be a part of this Agreement in such jurisdiction." This language was held to require application of California's state law giving a state motor vehicle board authority to determine whether there was good cause for termination.[90]

A better practice that addresses both these decisions would be to refer only to provisions of applicable law that cannot be waived and that are necessarily applicable notwithstanding a contractual choice of other law. Note also the importance of drafting a broadly applicable clause governing the rights of the parties, and not merely governing the agreement.[91]

Combining a choice of favorable law with an arbitration clause will enhance the likelihood of the choice of law being enforced. The strong federal policy in favor of arbitration, embodied in the Federal Arbitration Act,[92] generally has been held to support not only the provision for arbitration,[93] but also the parties' explicit choice of law to be applied in arbitrations, even in the face of explicit state law to the contrary.[94] Note, however, that where state law requires a disclosure that a choice of law or choice of forum provision may not be enforceable in that state, a question arises as to whether the parties really agreed to the contractual choice. The Ninth Circuit has held in such

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90 *Sterling Truck Corp. v. Sacramento Valley Ford Truck Sales*, 751 N.E.2d 517 (Ohio Ct. App. 2001), *appeal denied*, 748 N.E.2d 547 (Ohio 2001).

91 *See, Valley Juice Ltd., Inc. v. Evian Waters of France, Inc.*, 87 F.3d 604 (2d Cir. 1996) (choice of New York law to govern agreement did not preclude claim under Massachusetts "little FTC Act," as it would have had the agreement also stated rights of parties were to be governed by New York law).

92 9 U.S.C. §§ 1 *et seq.*

93 *See Doctor's Associates v. Casarotta*, 517 U.S. 681, 116, S. Ct. 1652 (1996); *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 115 S. Ct. 1212 (1995); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987); *Southland v. Keating*, 465 U.S. 1 (1984); *KKW Enterprises, Inc. v. Gloria Jean's Gourmet Coffees Franchising Corp.*, 84 F.3d 42 (1st Cir. July 19, 1999) (upholding clause calling for arbitration outside Rhode Island despite franchise law provision that contract requiring venue outside Rhode Island is unenforceable); *Doctor's Associates, Inc. v. Hamilton*, 150 F.3d 157 (2d Cir. 1998); *S+L+H S.p.A v. Miller - St. Nazianz, Inc.*, 988 F.2d 1518 (7th Cir. 1993); *Saturn Distribution Corp. v. Williams*, 905 F.2d 719 (4th Cir. 1990); *Mitsubishi Motors v. Soler Chrysler-Plymouth, Inc.*, 723 F.2d 155, 158 (1st Cir. 1983); *aff'd*, 473 U.S. 614 (1985); *Medika Int'l, Inc. v. Scanlan Int'l, Inc.*, 830 F. Supp. 81 (D.P.R. 1993); *Salon Brokers, Inc. v. Sebastian Int'l, Inc.*, BUS. FRAN. GUIDE (CCH) ¶ 9586 (Mich. Ct. App. 1990); *but see Hambell v. Alphagraphics Franchising, Inc.*, 779 F. Supp. 910 (E.D. Mich. 1991); *Sterling Truck Corp. v. Sacramento Valley Ford Truck Sales*, 751 N.E.2d 517 (Ohio Ct. App. 2001), *appeal denied*, 748 N.E.2d 547 (Ohio 2001) (arbitration clause superseded by state law granting California New Motor Vehicle Board authority to determine existence of good cause for termination, because of severability clause which provided that "any provision of this Agreement which in any way contravenes any law of any relevant jurisdiction shall be deemed not to be a part of this Agreement in such jurisdiction"); *Barter Exchange, Inc. of Chicago v. Barter Exchange, Inc.*, 238 Ill. App. 3d 187, 179 Ill. Dec. 354, 606 N.E.2d 186 (Ill. App. 1992, *app. denied*, 149 Ill. 2d 647, 183 Ill. Dec. 858, 612 N.E.2d 510 (Ill. 1993) (franchisor's failure to register under state franchise law made franchise agreement void, so arbitration clause was unenforceable); *contra, Cusamano v. Norell Health Care, Inc.*, 239 Ill. App.3d 648, 180 Ill. Dec. 352, 607 N.E.2d 246 (Ill. App. 1993) (rejecting *Barter Exchange, Inc. of Chicago, supra*, and enforcing arbitration, but rejecting choice of law clause).

94 *See, e.g., Medika Int'l, Inc. v. Scanlan Int'l., Inc.*, 830 F. Supp. 81 (D.P.R. 1993) (enforceability of choice of law provision was question for arbitrator); *Good(E) Business Systems, Inc. v. Raytheon Co.*, 614 F. Supp. 428, 430-31 (W.D. Wis. 1985); *see also Volt Information Sciences, Inc. v. Stanford University*, 489 U.S. 468 (1989) (choice of California law included California rules regarding arbitrability, which were applied to stay arbitration); *Yates v. Doctor's Assocs., Inc.* 140 Ill. Dec. 359, 193 Ill. App. 3d 431, 549 N.E.2d 1010 (Ill. App. 1990).

circumstances that a contractual choice of forum for arbitration was unenforceable in light of such a mandated disclaimer, finding that the franchisee had no reasonable expectation that it had agreed to an out-of-state forum.[95] Care should be taken in drafting arbitration clauses not to overreach. For example, the Ninth Circuit held an arbitration clause unconscionable, and so unenforceable, where franchisees were required to arbitrate, but the franchisor could proceed in court.[96]

In one case under Puerto Rico's restrictive Dealer Contract Act, a distributor's failure to give written notice of renewal as required by contract was held good cause for non-renewal.[97] The court stressed that the non-renewal there was occasioned by the *distributor's* non-renewal, not the supplier's. This suggests the inclusion of such a renewal requirement, although if the requirement is ignored for years and then suddenly enforced, the courts are likely to be unsympathetic to the supplier. In another such case, a contractual reservation of rights to sell to other dealers defeated a claim that such sales violated the same Dealers' Act.[98] Such non-exclusivity provisions can also serve to protect the supplier.

Finally, if all else fails, a supplier can avoid franchise law problems by avoiding distributors entirely and distributing its goods or services directly through employees or company-owned outlets, at least in those states where no other way to avoid a franchise law can be found.

E. *Conclusion*

In sum, there is an increasing number of states (and countries) that regulate a broad range of distribution arrangements. It is important for suppliers to be aware of the reach of these statutes so that they can avoid unwittingly being made subject to serious restrictions on their ability to control their own distribution systems. Similarly, distributors need to be aware of the broad range of rights provided by these statutes, so

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95 *Laxmi Investments, LLC v. Golf USA*, 193 F.2d 1095, (9th Cir. 1999); *see also Great Earth Companies, Inc. v. Simons*, 2000 WL 640829, BUS. FRAN. GUIDE (CCH) ¶ 11,823 (S.D.N.Y. 2000) (arbitration provision upheld but New York choice of forum unenforceable because franchisor had fraudulently misrepresented that Michigan Franchise Investment Law prohibited enforcement of out of state forum selection provision; franchisee reasonably relied on misrepresentation). *But see Bradley v. Harris Research, Inc.*, 2001 U.S. App. LEXIS 27284, BUS. FRAN. GUIDE (CCH) ¶ 12,221 (9th Cir. 2001) (Federal Arbitration Act preempts California Franchise Investment Act provision making non-California forum clause unenforceable; distinguishing *Laxmi*, because plaintiff failed to show UFOC language suggesting clause might be unenforceable); *Gingiss Int'l, Inc. v. L&H Tuxes, Inc.*, BUS. FRAN. GUIDE (CCH) ¶ 12,372 (N.D. Ill. 2002) at n.7 (criticizing *Laxmi* as disregarding preemptive effect of Federal Arbitration Act).

96 *Ticknor v. Choice Hotels Int'l*, 265 F.3d 931 (9th Cir. 2001); *See also Circuit City Stores, Inc. v. Adams*, 2002 WL 152986 (9th Cir. 2002) (arbitration clause unconscionable where employees had to arbitrate but employer did not, relief was limited, employee rights were otherwise restricted and employee had to share costs of arbitration); *Blair v. Scott Specialty Gases*, 283 F. 3d 595 (3rd Cir. 2002) (permitting plaintiff to show arbitration clause requiring her to pay half of arbitration costs imposed prohibitive burden that would prevent vindication of her statutory rights).

97 *Nike Int'l Ltd. v. Athletic Sales, Inc.*, 689 F. Supp. 1235 (D.P.R. 1988).

98 *Vulcan Tools of Puerto Rico v. Makita USA, Inc.*, 23 F.3d 564 (1st Cir. 1994). *See also Caribe Industrial Systems, Inc. v. National Starch and Chemical Co.*, 36 F. Supp. 2d 448, (D.P.R. 1999), *aff'd* 212 F.3d 26 (1st Cir. 2000) (non-exclusive nature of contract permitted supplier to sell directly to customers, bypassing distributor, as well as to sell through other dealers); *Harley-Davidson Motor Co. v. Motor Sport, Inc.*, 6 F. Supp. 2d 996 (E.D. Wis. 1998) (non-exclusive nature of agreement permits appointment of additional distributors).

that they may take full advantage of the favorable position in which the laws seek to place them.