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FRANCHISING

Evelyn M. Sommer*

I. Introduction

A. What Is A Franchise

A system of marketing and distribution whereby a small independent businessman (the franchisee) is granted - in return for a fee - the right to market the goods and services of another (the franchisor) in accordance with the established standards and practices of the franchisor, and with its assistance.[1] Franchising can be defined as a business system in which the owner of a mark licenses others to operate business outlets using a trademark or service mark to identify products or services that are made and/or advertised by the licensor-franchisor. In one sense, a franchise system is built upon a framework of trademark or service mark licenses fleshed out with various rights and obligations of the franchisor and franchisee. A franchisee falls somewhere on a spectrum in between full independent entrepreneur and a hired clerk in a company-owned outlet.

The economic underpinnings of franchising are to be found in the concept of uniformity. Two hallmarks are associated with franchise networks, a trademark conveying authenticity and exclusivity and a uniform product or service. The Big Mac tastes the same in Vermont as it does in Iowa, the restaurants look the same in New Hampshire as they do in New Jersey and the name outside is always the same around the globe. The public demands uniformity and through franchising, the public gets it.

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Tied to the definition of a “franchise” is a clear conception of the peculiar blend of independence and dependence that constitutes the particular business arrangement that is franchising. On the one hand, in a franchise relationship, the franchisee possesses an independence conferred by the franchisor insofar as the franchisee is granted the right to actually operate and own the franchise business. Part and parcel of this business independence is also financial independence; concomitant with the task of running the business, the franchisee bears the risk of failure if the business is not successful. Indeed, the franchisee actually purchases the right to operate and own the business from the franchisor by paying a “franchise fee.” On the other hand, the franchisee is also peculiarly dependent upon the franchisor insofar as the success of a franchise depends, in part, upon the method of operation provided by the franchisor and, in part, upon the preeminence and popularity of the commercial identity embodied in the franchisor’s proprietary marks. This particular convergence of independence and dependence is fundamental to a franchise.

Another aspect of the franchise relationship is that it involves a continuing commercial relationship. The FTC has indicated that a relationship is a “continuing” one if the parties reasonably anticipated at the time of entering into the relationship that it would involve an ongoing course of dealing over a period of time, (Sells Enter., Inc. FTC OP. Aug. 28, 1980). There are basically two classes of such "continuing" relationships: (a) "package and product franchise"; and (b) "business opportunity ventures."

Package franchises are defined as those in which the franchisor licenses the franchisee to do business under a prepackaged business format established by the franchisor which is closely identified with the franchisor's trademark. Familiar examples of such franchises include fast-food outlets, real estate brokerages, personnel services, motels, transmission centers, rustproofing services, and tax preparation services.

Product franchises are those in which either the business or the goods bear the franchisor's trademark, and the franchisee distributes goods produced by, or under the control or direction of, the franchisor. The most common examples of such distribution systems are cosmetics, automobile, and gasoline station distributorships. Three elements must be satisfied for a package or product franchise to exist: (i) distribution by the franchisee of goods and services associated with the franchisor's trademark; (ii) the franchisor's right to exercise significant control over, or the promise of significant assistance to, the franchisee's business methods; and (iii) a required payment by the franchisee to the franchisor of a fee.

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B. At the core of all franchising is the licensing of a trademarked product or service.[2] The license to use the trademark is the vehicle for the franchisee to become part of a business system with uniform format and quality standards. The necessity and the role of the trademark license depend on the type of franchise system at issue.

A trademark license is necessary if the franchisee manufactures and sells a product bearing the trademark to someone other than the trademark owner or those operating under license from the trademark owner.

It is also necessary if the franchisee uses the trademark in performing a service under license from the trademark owner, for example, as part of a franchising system.

A trademark license is not necessary if one party merely distributes or sells the product for the trademark owner without conducting business under the owner's mark or name. For example, a gas station franchisee does not need to obtain a trademark license from soda producers to sell sodas. A franchise is also not established where a trademark license has been granted as a result of a trademark infringement litigation.

The license is also unnecessary if one party manufactures the product for the trademark owner (or its licensees) and the trademark owner itself (or licensee) sells or distributes the product. For example, manufacturing T-shirts for the trademark owner's promotional use does not require a trademark license.

C. Some franchisors maintain that a franchise is merely an embellished license and therefore revocable at will. This however can prove to be a dangerous assumption

D. Some franchisees contend that a franchise is a license coupled with a fiduciary interest, not subject to unlimited control by franchisors.

E. The significant control or assistance element concerns the availability to the franchisee of the franchisor's expertise. The franchisor may transmit its expertise either by exercising control over, or by furnishing assistance to, the franchisee's method of operation. Such control or assistance, however, must be "significant." They relate to a franchisee's entire method of business operation; they are not "significant" if they relate only to the method of selling a specific product. Examples of significant controls over the franchisee's method of operation are those involving: (i) site approval for new businesses; (ii) site design or appearance requirements; (iii) operating hours; (iv) production techniques; (v) accounting practices; (vi) personnel policies and practices; (vii) promotional campaigns requiring franchisee participation or financial contribution; (viii) restrictions on customers; or (ix) location or sales area restrictions.

Examples of promises of assistance deemed "significant" include: (i) providing formal training programs (sales, repair, or business); (ii) establishing accounting systems; (iii) offering management, marketing, or personnel advice; (iv) selecting site locations; or (v) providing a detailed operating manual.

F. A franchisee meets the "required payment" element of the franchise definition if the franchisee is required to make payments to the franchisor. The payments may be "required" either by contract or by practical necessity. Payments required by contract would include not only those required by the franchise agreement, but also those required in any companion contracts which the parties may execute, such as payments made by a franchisee for rent, advertising, equipment, supplies, training, and other non-inventory items. Payments made by practical necessity include, among others, those for equipment that can be obtained only from the franchisor or an affiliate of the franchisor. (Red Wing Shoe Co., FTC Op. Jan. 7, 1983.)

With respect to the purchase of inventory from the franchisor, the Commission has determined that, because it is virtually impossible to draw the line between inventory that is purchased at the franchisee's option and that which is purchased as a matter of practical or contractual necessity, payments made to the franchisor for "reasonable amounts" of merchandise purchased at bonafide wholesale prices and for "resale" are not considered to be required payments. The requirement that the merchandise purchased be for "resale" effectively limits the exemption to purchases of inventory items. The Commission will construe "reasonable amounts" to mean amounts not in excess of those which a reasonable businessman normally would purchase as starting inventory or to maintain a going inventory or supply. (General Motors Corp., FTC Op. Aug. 17, 1979; Chrysler Corp., FTC Op. Aug. 10, 1979) (purchases of inventory at bona fide wholesale prices for resale do not constitute required payments if the amounts do not exceed that which a reasonable businessman would have in stock to maintain a going inventory or supply sufficient to meet reasonably anticipated demand).

The "bona fide wholesale price" exemption may be used by many companies which would otherwise be covered by the FTC Rule to avoid coverage. (Schwinn Bicycle Co., FTC Op. Aug. 3, 1979).

The term "franchise" has also been defined to include business venture opportunities. A business opportunity venture exists when each of the following elements is present:

(i) The franchisee sells goods or services supplied by the franchisor, its affiliate, or suppliers with which the franchisee is required by the franchisor to do business;

(ii) The franchisor secures retail outlets or accounts for the goods or services, or secures locations for vending devices or racks, or assists the franchisee in obtaining such services from others ("rack jobbing"); and

(iii) The franchisee is required to pay to the franchisor or an affiliate a fee. (Coin Op Sales Co., FTC Op. Oct. 19,1979).

Rack jobbing opportunities and vending machine routes are fairly typical examples of the traditional businesses that meet these criteria. FTC advisory opinions have added the possibility of a variety of ordinary distributorships, including distributorships for doors and windows, batteries and automobile lamps, and electronic game machines. (See e.g., Roman Enters., FTC Op. July 18, 1980; Garcia Mktg., FTC Op. May 29, 1980; and Yasmin Enters. Inc., FTC Op. March 27, 1980).

In contrast to the FTC Rule, the Notice of Proposed Rule Making (NPR) focuses exclusively on the sale of franchises. Accordingly, the NPR proposes to delete altogether the "business opportunity" definition (436.9(e)) from the Rule. The FTC acknowledges in the NPR that franchises and business opportunities are distinct arrangements that require separate disclosure approaches. The FTC has indicated that it expects to promulgate separately new regulations to address business opportunity sales.

G. It is quickly apparent that a universal definition for “franchise” does not appear in every jurisdiction's legislation, court decisions or regulations, and if such a definition did exist, it would fail to encompass the many functions inherent in the system. Moreover, such a definition would not give any indication of the system's complexity and potential for abuse.

In practice, the term "franchise" has been used to describe a vast array of different business arrangements involving any number of enterprises. As one author has noted, defining what constitutes a franchise is particularly difficult because franchising itself "embraces many types of relationships and distribution techniques, involving [a] ... myriad. . . [of products and services [including] such disparate bed-fellows as auto manufacturers, motels, muffler repair shops, restaurant operations, and funeral homes for pets." Norman D. Axelrod, Franchising, 26 Bus. Law 695 (1971). Another commentator attributed a large part of the difficulty of properly framing a definition of franchising to legislative zeal in seeking to cover all conceivable business arrangements. Martin D. Fern, 7he Overbroad Scope of franchise Regulations: A Definitional Dilemma, 34 Bus. Law, 1387 (1979).

One widely used definition states that a franchise is "an oral or written arrangement for a definite or indefinite period, in which a person grants to another person a license to use a trade name and in which there is a community of interest in the marketing of goods or services at wholesale, retail, leasing, or otherwise in a business operated under said license."[3]

Another definition is that found in California's Franchise Investment Law:

"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.

The California Guidelines provide that the trademark element is included so that the law may deal with the multiplicity of business establishments presented to the public as a unit or marketing concept operated under the coverage of a common symbol. In line with this objective, the California Guidelines provide that the trademark must be communicated to the customers of the franchisee in order to satisfy this element.

According to the California Guidelines, if no marketing plan or system is prescribed and the franchisee is entirely free to operate the business in accordance with his own marketing plan or system, there is no "franchise." The Guidelines indicate that centralized management and uniform standards regarding, among other things, the quality and price of the goods sold, are keys to determining whether there is a prescribed marketing plan or system. Accordingly, provisions contemplating a nationwide distribution grid and an arrangement designed to establish uniformity of prices and marketing terms will be considered a significant indication that there is a marketing plan or system. Similarly, control reserved over terms of payment by customers, credit practices, and warranties suggests a prescribed marketing plan. Further, if the franchisee must follow the franchisor's directions with respect to the selection of locations, the use of trade names, advertising, signs, sales pitches, sources of supply, the appearance of the unit, fixtures, equipment, uniforms, hours of operation, housekeeping, and similar matters, such factors also will be considered significant indicators that a marketing plan or system exists. A marketing plan or system prescribed by the franchisor also will be indicated if the franchisor exercises control over the franchisee by means of inspection, reporting requirements, advertising, or promotional programs.

Included in the statutory definition of "franchise fee" is any fee or charge that the franchisee is required to pay to the franchisor or its affiliate for the right to engage in the franchised business. A payment may be a "franchise fee" regardless of the designation given to, or the form of, such payment. (In some states, a "franchise fee" is considered such only when it exceeds a stated minimum amount, e.g., $100.)

New York General Business Law Act. 33 at § 681 defines a franchise as 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 the franchisee is required to pay, directly or indirectly, a franchise fee, or

2. A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate, and the franchisee is required to pay, directly or indirectly, a franchise fee.

The New York Franchise Act is perhaps the nation's toughest franchise law for the reason that New York's definition of the term "franchise" is the broadest in the nation, subsuming certain licensing, distribution and other arrangements which are not deemed to be "franchises" under any other federal or state franchising law, rule or regulation. (Act §681 [3])

The New York definition is in sharp contrast to that utilized by every other jurisdiction regulating the sale of franchises, where all three elements set forth above - -

"trademark", "marketing plan" and "franchise fee" -- must be present for a franchise to exist. In New York, either of the first two elements combined with the franchise fee component will suffice. This broadened definition of the term "franchise" thus covers many species of licenses, distributorships and other commercial relationships not previously concerned with franchise regulation.

Another definition of "franchise" adopted by a number of states is the "community of interest" which provides that "franchise" means (a) a contract or agreement, either express or implied, whether oral or written, for a definite or indefinite period, between two or more persons: (1) by which a franchisee is granted the right to engage in the business of offering or distributing goods or services using the franchisor's trade name, trademark, service mark, logotype, advertising, or other commercial symbol or related characteristics; (2) in which the franchisor and franchisee have a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement or otherwise; and (3) for which the franchisee pays, directly or indirectly, a franchise fee.... The determination whether a "community of interest" exists is distinct from the determination whether a marketing plan or system is prescribed. Satisfaction of the "community of interest" definition requires the franchisor and franchisee to have a substantial financial interest in common.

H. While there are many different forms and kinds, franchises may be divided into four basic types.

1. A manufacturing franchise is one in which the franchisor permits franchisees to make and sell products using either raw materials and/or specifications supplied by the franchisor. Examples are mattress and bedding manufacturing and the local bottling and canning of soft drinks.

2. A distributing franchise is one in which the primary purpose is for the franchisee to serve as an outlet for products manufactured by or for the franchisor. Examples are franchised sales outlets for bicycles, automobiles, and gasoline.

Its purpose is to provide the franchisor with a distribution system to market its products. It is similar to an ordinary supplier-dealer relationship, but the franchisee has a greater identification with the franchisor's trademark and might be precluded from selling competitors' products. Examples include soft drink bottlers, gas stations and automobile dealerships.

Manufacturing and distributing type franchises are frequently considered as one category i.e., product and trade name franchising. This category accounts for an estimated 75% of all franchise sales. Franchisees concentrate on one company's product line and acquire the identity of the product supplier.

3. A licensing or "business format" franchise is one in which the franchisor is primarily licensing a business format or system, rather than selling goods identified with the franchisor. Under a business format franchise relationship, the franchisor provides a license under a mark and also provides a business format for the retail sale of goods or services under the mark. The franchisor typically does not manufacture any products but may offer to supply equipment, ingredients, raw materials, packaging materials, advertising, and so forth. The franchisee typically performs services but may sell products in conjunction with those services. The franchisee usually deals exclusively in the franchisor's sponsored services and is required to adopt the franchisor's mark and overall presentation format as its exclusive trade identity. Examples include restaurants, convenience stores, hotels, motels, and auto repair centers, car rental, real estate brokerage chains and temporary employment services. The best known

example is the fast food franchise. In this type of franchise, the franchisee is primarily paying for the use of a franchisor's well-known and advertised mark together with training, operating specifications, and business know-how supplied by the franchisor.

4. Under an affiliation franchise relationship, the franchisor recruits into its system as licensees persons who are already established in the particular line of business. Each of the businesses is required to adopt and use the franchisor's mark, but they may be permitted to continue using their own marks as secondary marks. These businesses rarely use the same overall presentation or identity format except for the mark itself. Examples are insurance, financial, and real estate brokerage services.

5. Co-branding involves a situation in which a single outlet is franchised by two or more franchisors (such as Baskin-Robins/Dunkin Donuts) sometimes under two or more separate agreements, other times under a single multiconcept agreement.

II. Mutual Business Contributions

A. Theoretically, franchising represents the ideal compromise between big business and small businessmen. The franchisor assumes the economic functions of big business, and the franchisee contributes capital and entrepreneurship by becoming an owner-manager.[4]

B. The franchisor obtains new sources of expansion capital, new distribution markets and self-motivated vendors of its products, while the franchisee acquires the products, expertise, stability and marketing savvy usually reserved only for larger enterprises.[5]

C. Franchising is the evolutionary business response to the massive amounts of capital required to establish and operate a company-owned network of product or service vendors.

D. As the United States became more industrialized in the late 18th and early 19th centuries, national brands and nationally known vendors came into being and reworked the American economic landscape.[6]

E. Franchised businesses now account for more than $1 trillion dollars in annual sales, 30% of the Gross National Product and over 41% of all retail sales. By the mid 1990s, of every 12 businesses in the United States was a franchise operation. Nationwide, there were more than 2,500 franchisors. Over 8 million people in over 600,000 franchise outlets were employed in franchise operations.[7]

III. Business Advantages of Franchises

The benefits of franchising may perhaps be best understood by considering the following startling statistic: While the average rate of failure for new businesses is 65% within five years from inception, a 1991 study by Arthur Andersen & Company of 366 franchise companies in 60 industries revealed that nearly 86% of all franchise operations opened in the prior five years were still alive and under the same ownership; only 3% were no longer in business.

A recent study prepared for the International Franchise Association reveals that only 3 - 11% of franchised units (varying by industry segment) suffer "turnover" in any given year ("turnover", in this context, is defined to mean closure of the subject unit or sale to a non-franchised purchaser). And even these low figures may themselves be inflated, since often the franchised unit may be closed or sold for reasons other than "failure", such as death or retirement.

From the franchisor's point of the view, the franchise method is advantageous because it permits the franchisor to quickly set up and maintain a relatively large number of outlets using the capital investments of the franchisees. From the franchisees' point of view, the franchise method is attractive because the franchisee is given access to a proven and organized product or service that has been advertised and is known to customers. Rather than start from zero with its own mark and its own know-how, a small business person who opts to become a franchisee has the advantage of plugging into a existing system and becoming a partially independent entrepreneur.

IV. Franchisor's Benefits

A. In the ideal situation, the franchisor has almost unlimited opportunities to perform valid functions and be richly rewarded for that effort. At the inception, franchisees are independent businessmen, providing the talent, inspiration and enthusiasm epitomized in the phrase "local entrepreneur." They can decipher local requirements because of their direct customer contact. The goodwill engendered in that contact is meaningful as well. These attributes are frequently cited as the most fundamental attraction for the franchisor.[8]

B. The franchisor without the expenditure of any capital whatsoever, but instead with an infusion of capital - may engage in rapid system expansion and market penetration. This rapidity of growth is normally measured in terms of years rather than decades, as had previously been the case with national company owned chains. Further, since the franchisor often owns units itself, and since those units are normally more profitable than franchised units, the franchisor will frequently set up a nationwide network but retain for itself the most profitable units. Finally, the franchisor acquires the aggressive self-motivation of franchisees, whose ownership fervor is generally far greater than that of employee managers.[9]

C. In the purely financial sense, the franchisor may reap generous rewards from a variety of sources. It may obtain a substantial fee for the sale of the franchise, regardless of whether the fee is paid in full or paid in installments. In the service industries, the franchisor will usually charge a royalty for the use of the mark and the business system. This may consist of a percentage royalty on gross sales or purchases, a fixed monthly charge, or any of a wide variety of methods that reflect payment based on usage. Additionally, where the franchisor is also the manufacturer or wholesaler for any of the products or services used by the franchisee, the franchisor has an opportunity to obtain a profit for its valid functions. The availability of an assured distribution network may considerably increase the manufacturer's profits by reducing the need for large inventory, by providing an assured demand, and by eliminating wide fluctuations in sales and close-outs. Further, there may be other economies of scale in the production, storage, and handling of products.[10]

D. Other indirect sources of income that do not transgress the rules of fair play and disclosure are available to the franchisor. For example, the franchisor may provide an extensive credit- network, both to the franchisees and to their customers. One step removed from this would be the indirect extension of credit by the acquisition of capital facilities through purchase, lease, mortgage, or otherwise, with possession or use being made available to the franchisee on reasonable terms commensurate with the franchisor's exposure to risk. In some industries, this financial support may extend to the inventory itself.[11]

E. Non-financial benefits to the franchisor includes the ability to motivate and control huge numbers of indirect employees. A company may not be able to afford the cost of an administrative hierarchy, including high salaries, to handle those employees. Franchisors also avoid a certain amount of risk inherent in most businesses. Whether a regional milk dairy or a major oil company, it may be absolutely dependent upon an assured and constant source of demand for its products or may lack adequate local storage to offset the vagaries of market demand. The franchisor also receives the benefit of the constant accretion to the value of its trademark or service mark. The actual premises, the franchisee's services and their devotion to duty all materially enhance the mark's value to the franchisees, to other franchisees and to the franchisor. [12]

V. Franchisee's Benefits

A. At inception, the franchisor should provide a trademark or service mark that is nationally known. The purpose is to provide an attractive reputation that is recognized by the consumers with whom the franchisees will deal. In an ideal situation, the franchisee's success lies in complying with the standards formulated by the franchisor, both as to quality and as to uniformity. This emphasis is meant to facilitate the obtaining and maintenance of the nationally-known goodwill for the products or services. While fulfilling these obligations to the customer, the franchisee benefits by the guidance provided by the franchisor in the form of business standards. The franchisee should obtain internal benefits from a standardized management system and methods of internal control, including marketing and inventory controls and standardized bookkeeping. The franchisee will benefit externally from producing better results in its individual operations, while increasing customer acceptance throughout the system.

B. Franchisor can also provide expert guidance in capital matters like site selection, design and engineering of the facility, layout, choice and sources for equipment, furnishings, supplies and even general contractor services. Where facilities are to be leased or purchased, the franchisor may provide expert advice, negotiating talent, or financial assistance through a pledge of credit. In the operation of the enterprise, the franchisor should provide a proven system of operations through training, a Manual of Operations, supervision, research, bulletins and refresher courses. There may be extensive benefits obtainable through bulk purchasing, buying techniques, or sources of supply. Where the franchisor is a manufacturer, the franchise family can provide a variety of cost-savings that can be passed down the line. All of this may be enhanced by the constant availability of the franchisor's highly-trained team of experts. These advantages are what franchisees usually seek. They are what franchisors impliedly offer. Underlying the franchisor's promise and the franchisee's goal is the offering of a business in which the franchisee will have a reasonable opportunity to succeed in developing a business of her own.[14]

VI. Structuring a Franchise System

A. For the most part a prospective franchisee has little choice but to put his entire faith and confidence-in the franchisor. The franchisee most often assumes that the franchisor has worked out a functional system for merchandising his product or services, and that the system can work for the mutual benefit of both parties. In order for that to really happen, the franchisor must try to assemble all of the expertise that may be required in the particular business in which he proposes to engage. Unfortunately, many franchisors think of their prime business as the sale of franchises, rather than the operation of the franchise that may be purchased by the franchisee. For this reason, a franchisee must engage not only an attorney to draw up a set of documents, but also and primarily a business team to gather all the expertise in the creation of the entity from which the franchise will operate. From sources of supply to advertising, to orders, payments, credits, discounts, the franchisee must look to the franchisor for total guidance in every material aspect of the franchise relationship.[15]

B. Franchising is a creature of contract. The franchise agreement or franchise contract embodies the entire relationship between franchisor and franchisee. The entire structure of a franchise system will be contained in a series of franchise agreements, which set forth in detail the rights, duties, obligations and activities which each party pledges to undertake and perform. A number of different species of franchise agreements and relationships may exist to properly implement the franchisor's business objectives, including unit franchises, area franchises, master franchises and subfranchises. The core relationship, however, is the unit franchise relationship in which a franchisee is given the right to open and operate one - and only one - franchise outlet, usually at a specified location or within a designated territory. Accordingly, a potential franchisor's central question is how the unit franchise relationship should be memorialized in a franchise agreement to properly protect and advance the franchisor's interests and goals.[16]

C. The beginning point of the franchise relationship is the terms of the franchise relationship. How long is the franchisor granting franchise rights to its franchisees? This is not an easy question to answer. If the term is too short it will attract few, if any, buyers. Franchisees are purchasing a business opportunity where time is needed to develop name recognition, to maximize good will and to recoup their investment. If the term of the franchise is too long, problems can arise. The franchisor may be stuck with a less than desirable franchisee who is unwilling or unable to operate the franchise successfully. If this is so, valuable locations may be sacrificed. Since many franchise agreements call for franchisees to upgrade and refurbish their franchise locations at the end of the franchise term and upon renewal, too long a franchise term can result in older franchise units downgrading-the image the franchisor is trying so hard to present.[17]

Finally, franchise terms that are excessive in length prevent the franchisor from adjusting the economics of the relationship as time goes on. In other words, the economic balance struck this year in terms of royalties and advertising contributions may be totally out of line in the year 2010, either to the franchisor's or the franchisee's disadvantage. While this imbalance can be rectified upon expiration of the initial term of the franchise, if that term is too long, the imbalance can destroy a franchise system. [18]

For franchises involving significant investments by franchisees, such as restaurants, the typical term of the franchise is ten years, with an option exercisable by the franchisee for another ten years if the franchisee has been in compliance. In instances where a heavy investment by a franchisee is not required, a very short franchise term can be imposed with guaranteed rights of renewal to achieve certain strategic purposes.

D. Another key feature of the franchise structure is the grant of territorial rights. It is most common for franchisors to confer upon franchisees some degree of territorial protection for their businesses, often under the misleading heading "exclusive territory." This is misleading because no franchised territory is ever truly "exclusive." If nothing else, termination of the franchise agreement defeats any claimed "exclusivity." Also, while the franchisor can promise not to own or franchise other units within a franchisee's territory, a franchisor is hard pressed to prevent its franchisees from marketing in other franchisees' territories. Such restraints may constitute violations of applicable antitrust laws. For this reason, many franchisors include a recital in the franchise agreement that no marketing exclusivity is conferred in connection with a grant of a so called "exclusive territory." [19]

E. Selection of the franchise location and the construction of the franchise unit are of prime importance in structuring a franchise system. A franchise agreement will state whether the franchisor or franchisee will select the franchise site. Where the franchisor is responsible for this, the franchisee should consider that a clause wherein the franchisor assumes responsibility for assuring that the site will be successful be included in the franchise agreement. Where it is the franchisee's choice, the franchisor should consider a clause to insure that the franchisee follows the appropriate standards and specifications with regard to any location selected be included in the agreement. Franchisor approval of any franchisee-selected site should always be provided for. Further, any relocation rights should be addressed as well. The franchise agreement should specify whether a franchisee will be permitted to close a location and relocate the franchised business and, if so, under what conditions. It is not uncommon for franchisors to insist on prior written approval, coupled with the right to conduct an on-site inspection of the new site and the right to impose a relocation fee.[20]

In connection with any franchise location, the franchisee's lease provisions are of paramount concern to the franchisor. The franchisor will want the absolute right to approve the lease and that the lease not create obligations running to the franchisor. The lease should also not be assignable without the express written approval of the franchisor. Further, any franchise location lease should give the franchisor the option to step in, in the event the franchisee defaults, and take over the franchise premises or assign it to another franchisee.

F. No franchise agreement would be complete without providing for franchisor revenue. The initial franchisee fee has to be specified, the continuing royalty has to be set forth and the advertising contribution requirement has to be recited.

In addition, if the franchisor has additional profit centers and will derive income from the franchise in other ways, these must be carefully delineated. The sale of products/services to franchisees; the subleasing of real estate to the franchisee by the franchisor; the franchisor's furnishing "turnkey" sites; equipment/buildout financing programs; the sale of bookkeeping or accounting services; the rendition of consultation services; any market analysis or media buying activities which the franchisor will engage in on behalf of its franchisees, each and all must be spelled out with precision.

Advertising is critical to the success of most franchise systems. The most common advertising provisions found in unit franchise agreements call upon franchisees to contribute a percentage of their gross revenues to a national or regional advertising program administered by the franchisor, sometimes with franchisee input or assistance. Of paramount importance from a trademark control perspective is the franchise agreement's absolute prohibition against franchisees engaging in any advertising or promotional programs which have not been approved in advanced by the franchisor. An advertising submission and approval procedure should be set forth.

G. The franchise relationship must be structured very carefully with regard to a franchisee's sale of the franchise. A franchisor has every right to protect itself and its system from undesirable franchisees. It is critical to restrain any sale of the franchise to an individual or entity who doesn't meet the franchisor's standards. It is not unreasonable to require a proposed purchaser to present his personal and business credentials to the franchisor for review. The proposed purchaser of the franchise should demonstrate to the franchisor's satisfaction that he/she has the skills, qualifications and economic resources necessary to conduct the franchise's operation.

If a transfer fee is to be imposed, that should be specified in the franchise agreement. In addition, the agreement must make clear whether the assignee/franchisee will assume the original franchise agreement, or will enter into a new franchise agreement with the franchisor. Finally, the sale of a franchise is a good time to make the purchasing franchisee, at his expense, upgrade the franchise premises to conform to the then-current standards of the franchisor.

Twenty-one states and the District of Columbia presently have laws that regulate aspects of the franchisor-franchisee relationship. The following list identifies examples of franchisor conduct that may be prohibited by one or more of these statutes:

- imposition of unreasonable and arbitrary standards of conduct;
- prohibitions against the right of free association among franchisees;
- refusal to deal with franchisees in a commercially reasonable manner and in good faith;
- discrimination among franchisees on the basis of color, race, religion, sex, national origin, or disability of franchisee, or the racial, ethnic, religious, national origin or disability composition of a neighborhood or geographic area in which the franchise is located;
- discrimination among franchisees in charges offered or made for royalties, goods, services equipment, rentals, advertising services, or any other business dealing;
- establishment of a company-owned or franchised business at a location within the franchisee's exclusive territory or in "unreasonable proximity" to an existing franchised unit;
- requirement that a franchisee consent to a release, assignment, novation, waiver, or estoppel at the time of entering into a franchise agreement;
- termination of or failure to renew a franchise without adequate notice and good cause;
- a requirement to repurchase certain items from a franchisee upon termination or non-renewal;
- restrictions on the sale or transfer of a franchisee's franchise or business;
- unreasonable requirement that a franchisee purchase or lease goods or services from designated sources;
- receipt of undisclosed consideration from a person with whom the franchisees do business,

which consideration is directly related to purchases by the franchisees from that person;

- enforcement of unreasonable covenants not to compete;
- entry into franchise agreements with terms of inadequate length;
- modification of franchise agreements by franchisors without the consent of franchisees;
- prohibition on change in management of the franchisee;
- failure to use for the franchisee's benefit fees collected for an advertising fund;
- requirement that a franchisee waive its right to trial or consent to liquidated damages, termination penalties, or judgment notes;
- misrepresentations of a franchisee's chances for success; and
- requirement that a franchisee pay a security deposit.

H. The worst of all worlds for a franchisor is to be stuck with a "bad apple" franchisee and vice versa. Accordingly, the franchise agreement must be explicit regarding the acts, omissions and/or courses of conduct which will give rise to termination of the franchise. Termination provisions vary in accordance with what the franchisor wants to protect. Typical provisions give the franchisor the right to immediately terminate, or terminate after notice and a failure to cure, based on bankruptcy or insolvency, attempted improper transfer; failure to submit to inspection by the franchisor, improper disclosure of confidential information; criminal conviction; failure to adhere to the operating manual; breach of the covenant not to compete; failure to commence operations within the required time period; danger to public health or safety; filing of false reports to the franchisor; concealment of revenues; failure to deal fairly and honestly with employees and the public; failure to pay monies due to the franchisor under the franchise agreement; and, sale of unauthorized goods or services at the franchised outlet. This is not an exhaustive list, only a recital of some of the more important termination provisions.

If a state termination statute applies to a particular franchise relationship, the franchisor must comply with the statute in order to lawfully terminate a franchisee. Although the procedural requirements differ from state to state, they fall into three general categories:

Termination statutes generally prohibit a franchisor from terminating a franchisee without providing prior notice, as well as identifying the rationale for termination. Prior notice is stated to be written notice sufficiently in advance to afford a reasonable opportunity to cure the default.

Even when a franchisor does not need to provide notice sufficiently in advance to afford the franchisee an opportunity to cure, separate provisions may require that an opportunity to cure be provided.

The notice requirement may not apply under certain circumstances. For example, some states do not require notice in the event that a franchisee becomes bankrupt, abandons the franchise, is convicted of a crime, or tenders an insufficient funds check. In other cases, although the notice requirement is not waived, termination is permitted to be effective upon receipt of notice by the franchisee. For example, in some states, immediate termination is permitted should the franchisee be convicted of a crime relating to the franchise; become insolvent or bankrupt; default in amounts owed to the franchisor; falsify records or reports; or lose the right to occupy the premises. In other cases, termination may be effective twenty-four hours after notice of termination for failure to cure a default materially impairing the goodwill associated with the franchisor's trademarks. In still another case, termination on the grounds of voluntary abandonment of the franchise may not take place until fifteen days after notice of termination is furnished.

Despite such statutory requirements, the courts do not always require strict compliance in compelling circumstances.

By and large, the state termination statutes state that a franchise relationship cannot be terminated unless the franchisor has a good reason for the termination, and "good reason" is tested against such standards as "good cause," "just cause," and "reasonable cause."

Among the examples of good cause presently set forth in state termination statutes are: (i) failure to comply substantially with the requirements imposed by the franchisor, where those requirements are imposed equally on other franchisees; (ii) failure to act in good faith and in a commercially reasonable manner; (iii) voluntary abandonment of the franchise; (iv) felony conviction of the franchisee; (v) franchisee impairment of the franchisor's trademark or trade name; (vi) insolvency or institution of bankruptcy proceedings; (vii) loss of the right to occupy the premises from which the franchised business is operated; (viii) failure to pay the franchisor, within ten days of receipt of notice, any sums past due; (ix) failure to comply with state or federal law; and (x) repetition of a default after cure, or repeated failure to comply with franchise agreement, whether or not cured.

There is also the question of compensation The termination statutes present any number of approaches to the franchisor's repurchase obligations. The basic objective is to require the franchisor to compensate the franchisee for certain assets of the franchised business upon termination.

Assuming that the law has been complied with and that a franchisee has been properly terminated, the rights and obligations of the parties following termination or expiration must be fully addressed in the franchise agreement. At a minimum, the agreement must provide that upon termination or expiration of the franchise, the franchisee loses all rights to hold himself/herself out as a franchisee; loses all rights to the franchisor's name and marks; and, loses all rights to the franchisor's confidential information and know-how.

On a more positive note, the franchise agreement should address franchise renewal. First of all, it is important to point out that a number of states have laws which seek to protect franchisees from arbitrary non-renewal. These states seek to protect the franchisee's investment of time and money by furnishing standards governing renewal. Each statute varies from the others and there is no precise standard applicable nationwide pertaining to when a franchisor must renew a franchise agreement. However, the general conception of these state laws is that a franchisor must renew a franchise agreement unless there is "good cause" for non-renewal. Accordingly, franchise agreement renewal provisions must be customized on a state-by-state basis.

This being addressed, the mechanics of renewal should be specified in the franchise agreement. Renewal procedures should be carefully outlined with the following issues specifically addressed: Will there be a renewal fee? Will the boundaries of the franchisee's "exclusive territory" remain the same? Will the advertising contribution remain the same?

I. There are several different ways the franchise relationship can be structured. Two types of franchise relationships are the individual or unit franchises and area franchises.

Individual or unit franchises are those in which a franchisee is granted the right to develop and operate one outlet at a specific location or within a defined territory. Rights to acquire additional franchises may be granted within a defined area, subject to performance criteria and structured as either options or rights of first refusal. Rights of first refusal, however, will make it more difficult to attract qualified buyers for locations that are subject to such rights.

Unit franchises may also be offered as an incentive for growth for existing franchise owners, with additional franchises granted to successful franchisees. Franchisors should exercise caution in granting any sort of contractual obligation to grant additional unit franchises. Most companies simply adopt company wide policies regarding the incentive program.

The typical uses of an individual or unit franchise are as follows:

1. For a service business, in which the expertise of the franchisee is critical to the success of the operation. Some examples of service businesses are real estate, home inspection, and dental businesses.

2. For businesses requiring an owner-operator.

3. For active investors who are willing to "get their hands dirty." This type of franchise would not be appropriate for a passive investor.

Area franchises are those with multiple outlet franchises or area development agreements and may include subfranchisors and master franchisors. Under these arrangements, a franchisee may be granted the right to develop and operate two or more outlets within a defined territory or, in some instances, the right to subfranchise some of these development responsibilities. Following are the significant elements of an area franchise agreement:

1. Territory and exclusivity
2. The number of outlets to be developed
3. The time frames for development
4. Franchisor assistance in development
5. Fee obligations

6. Site selection and approval responsibilities of the parties

7. Termination and its consequences (i.e., the effect of termination of the development agreement on existing individual outlet franchises and the effect of termination of outlet franchises on the development agreement and other outlet franchises must be addressed).

In area franchises, a single development agreement is used to grant development rights for all outlets to be developed by the franchisee. Separate franchise agreements are then used to grant specific rights related to each outlet. Minority ownership of individual outlets (such as by outlet managers or passive investors) may be permitted.

Typically, area franchises are used for businesses that require a single franchise owner in a market to avoid encroachment and advertising problems that might otherwise arise if multiple owners develop a single market. Area franchises may also be attractive for businesses able to sustain a salary of an onsite manager, supervised by a franchisee owning multiple units. Given the management aspects of area franchise development, area franchisees should expect to have management experience and people skills.

It should be noted that the United States franchisee population has dramatically changed over the past decade. While franchising's roots may be traced to the grant of an individual franchise to one entrepreneur (or a small group of entrepreneurs) possessing no prior knowledge of or experience in the subject industry (sometimes referred to as "mom and pop" operations), it is nevertheless the case that over the past decade many of America's oldest and largest franchisors do not follow that paradigm. Instead, they find it far more efficient and profitable for all concerned to largely restrict the grant of United States franchises to: (i) sophisticated corporations with the resources and background necessary to optimally operate subject franchises, and (ii) existing franchisees whose experience, profitability and mastery of the franchisor's system strongly suggest future success.

Sometimes, this determination results in the grant of multiple unit franchise rights within a defined geographic area (city/county/state/region of the United States). Other times, a franchisor elects to only grant new domestic franchises to pre-existing and proven franchisees. Yet other times, franchisors will grant franchise rights to non-traditional locations to sophisticated entities having vast experience in operating in such environments (as when major quick serve restaurant franchisors afford franchise rights to experienced guest lodging chains for room service, or when other quick serve fanchisors grant franchises for the operation of airport units to large entities having vast experience in institutional food service operations).

The economic logic underlying these trends is compelling. With regard to restricting the grant of domestic franchises only to experienced franchisees, the logic is simple: instead of assuming the risk of an unknown, untrained and inexperienced franchisee candidate, it is far better to grant the subject franchise to an experienced franchisee whose qualifications, skills, background and financial wherewithal are already known to the franchisor; who has already undergone training; who has mastered the many details of the franchisor's system; and, whose previous successful operation of a franchised unit (with all of the managerial, operational and financial skills required) strongly suggests future success at the newly franchised location. Similar logic pertains to a franchisor's grant of franchises to large corporations with significant net worth and substantial experience in the subject industry. Sometimes these two trends merge, one major franchisor, which dominates its quick serve restaurant market segment, has as its largest franchisee a corporation which operates over 800 franchised restaurants; is a publicly traded corporation listed on the New York Stock Exchange; and until recently, also served as the franchisor of another, smaller quick serve restaurant chain.

As reported in the December 1, 1999 edition of Restaurant Business, "the top 50 American restaurant franchisees (in terms of U.S. sales) collectively own and operate over 7,500 units" (citing Restaurant Franchise Monitor's "Top 200 Franchisee List").

VII. An Overview of the Law of Franchising

The franchise industry has been plagued by numerous cases of abuses and misrepresentations aimed at unsophisticated prospective franchisees. Widespread instances have been documented involving such malpractices as high pressure franchise sales tactics, unscrupulous and inexperienced franchisors, financially unstable franchisors, hidden fee requirements and kick-backs, failure to provide information on services and training to be furnished to the franchisee, and use of coercive methods to get quick large deposits. 43 Fed. Reg. 59,614, 59,625 (1978).

Until the 1970's, the only so-called "franchise law" which existed was that body of law affecting business in general, with a special emphasis placed on federal antitrust law and the Lanham Trademark Act.

The response to the identification of the considerable abuses in franchising was a wave of legislation designed to protect prospective franchisees from abuses connected with the offer and sale of franchises. The first piece of legislation generally regulating the sale of franchises was the California Franchise Investment Law (CFIL), which became effective on January 1, 1971. See Ca. Corp. Code 31000-31516 (West 1998). The California legislation was followed by action at the federal level in the form of a Federal Trade Commission Franchise Rule (FTC)

Rule, and at the state level with enactments in nineteen jurisdictions, including: Alabama, Arkansas, Florida, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, Mississippi, New York, North Dakota, Oregon, Rhode Island, South Dakota, Texas, Virginia, Washington, Wisconsin and the District of Columbia.

The FTC adopted its rule concerning Disclosure Requirements and Prohibitions Concerning Franchises and Business Opportunity Ventures, 16 C.F.R. 436 (1978) pursuant to the Federal Trade Commission Act, 15 U.S.C.A. 41 (1984) (West 1974). The FTC Rule mandates that specified written disclosures be made at specified times and specified formats in connection with the offering and sale of franchises and business opportunities. 16 C.F.R. 436 n.1 (1978). Its status as a federal regulation would generally cause the FTC Rule to preempt state and local legislation and regulations to the extent that such provisions are inconsistent with it, the FTC Rule itself notes that it does not preempt state laws providing protection equal to or greater than that afforded by the FTC Rule. 16 C.F.R. 436 n.2 (1978).

The advertising and selling of franchises is strictly regulated by both the Federal Trade Commission (FTC) and various state laws (*supra*). For example the FTC has minimum disclosure requirements, which detail the kind of information that must be disclosed to prospective franchisees. See J. T. McCarthy, Trademark and Unfair Competition § 18:23 (2d ed. 1984). In some states, a violation of the state franchise disclosure law entitles the franchisee to rescind the agreement and recover royalties it has paid. My Pie Int'l Inc. v. Debould Inc., 687 F.2d 919, 220 USPQ 398 (7th Cir. 1982).

As to tort liability of franchisor, under various theories of tort and contract law, a franchisor generally will be held liable for the torts of franchisees. This includes legal responsibility for both personal injury and property damages resulting from defective products or negligently rendered services. See J. T. McCarthy, Trademarks and Unfair Competition § 18:24 (24 ed. 1984).

A. Before the modem franchising system developed, the courts tended to apply traditional principles of contract law to franchise contract issues, real property law to real property issues, and the like, without recognizing the unique character of the franchisor-franchisee relationship. However, as the franchising concept began to expand rapidly through the economy over the last three decades, so too did the case law. The number of judicial decisions directly involving business format or chain-style franchising problems increased annually. Today, there is a recognized distinct body of law specifically dealing with the major concerns of the franchising industry and the franchising parties. [21]

B. Because an intellectual property license lies at the core of a franchise, the laws governing the licensing of intellectual property constitute the heart and arteries of franchise laws. Each of the four bodies of intellectual property law protects different property rights. Trademark law protects one's right to use a distinctive word, symbol, or other device to identify the "source" of goods or services and prevent confusion by competitors using sindiar words, symbols, or devices. Trade secrets law protects one's right to maintain secrecy and control the use of secret information that provides one company a competitive advantage over others. Copyright law protects an author's original expressions and the exclusive right to copy, display, distribute, perform, or use a work as the basis for derivative works. Patent law grants rights to inventors of new and useful machines, aesthetic designs, and useful methods of doing things. A patentee receives the right to exclude others from using his or her discovery without consent.[22]

C. The key challenge for the franchisor is to control who may use its intellectual property and to restrict that use in the franchise agreement to foster a uniform standard among the system's independently owned operations. Without this control in the license agreement, anyone would be able to use a franchisor's name, know-how, and creative works in any manner in derogation of the owner's intellectual property rights. Under those circumstances, franchisors would have little to license and entrepreneurs would have little incentive to develop franchise programs.[23]

1. Trademark Law

While all four kinds of intellectual property can be found in franchising, trademarks historically have ranked first in importance because of industry's heavy reliance on manufacturing and distribution of goods.[24] Soft drink bottling, dating back to the late nineteenth century, was one of the earliest examples of franchising, followed by auto dealerships and gas station franchises. Franchisees facilitated the expansion of these franchise systems by investing their own funds and managing the local franchise businesses. In each case, the parent company owned the trademarks, provided the standards for uniformity throughout the systems and created a marketing image. As a result, "Coke," "Pepsi," and "7Up" are bottled and sold throughout the world today by independent, franchised bottlers.[25]

a. Under the Lanham Act a licensor must exercise quality control over the licensee or nsk loss of the trademark.[26]

b. The Lanham Act does not immunize franchisors from the anti-trust laws.[27]

c. The Lanham Act does not contravene the protective measures adopted by many states such as in the prohibition of any termination or failure to renew a franchise except for "good cause"[28]

d. Because the term "quality" and its usual companion "uniformity" are claimed to condone subjective standards for the "control" required by the Lanham Act, the franchisor's discretionary control may create a fiduciary relationship.[29]

2. Trade Dress Law

The courts have held that a franchisor, like any business, has no protectable interest in the mere method and style of doing business. The functional elements of a business are not considered protectable against competition from others. In some cases, however, functional elements may be distinguished from the total image of a business, comprising its trade dress. Recent decisions of the Supreme Court and the courts of appeals grant more protection to business methods. *State StreetBank and Trust Co. v. Signature Financial Group*, 149 F.3d 1368 (Fed. Cir. 1998). The same is true in protection afforded to the owner of trade dress. *Two Pesos, Inc. v. Taco Cabana Int'l Inc.*, 505 U.S. 763.(1992) (9th Cir. 1987). For example, in 1978 a federal court refused to enjoin a franchisee from opening a restaurant that was "strikingly similar" to the franchisor's restaurant motif. *Fuddruckers, Inc. v. Doc's B.R Others, Inc.* 826 F.2d 83. More recently, however, in factually similar circumstances, the courts have been willing to enjoin the use of similar restaurant motifs. The total image of a business may include the physical (geometrical) shape and appearance of a business, signage, choice of color, floor plan, decor, list of services or menu, choice of equipment, staff uniforms, and other features reflecting a total image, *Taco Cabana Intl, Inc. v. Two Pesos, Inc.*, 932 F.2d 1113, (5th Cir. 1991), affd., 505 U.S. 763 (1992). When these elements are viewed by a court as non-functional, either individually or in combination, they may be protected against use by someone else without the owner's consent. Moreover, even when some elements of a business's image are functional, if the particular combination of elements is not functional, that combination is also protected against appropriation by another.

D. Disputes involving the use of intellectual property in a franchise relationship generally fall into one of two categories: (i) efforts to stop someone from using the franchisor's intellectual property or conversely, efforts by a franchisee or competitor to use that property; and (ii) a claim that the property was not used according to the franchisor's rules as stated in the license agreement. Trademark disputes generally test a franchisor's ability to require a franchisee to stop using a mark it was previously licensed to use. For example, the franchisor will seek to enjoin the continued use of a trademark by the (former) franchisee after the franchise agreement ends. This contrasts with trademark disputes outside the realm of franchising, which typically involve questions about who owns a purported trademark or whether trademark rights have been established.[30]

E. Another example of a trademark dispute in the realm of franchise agreements exists where a party seeks to impose vicarious liability on franchisors for acts committed by the franchisees. Perhaps the most publicized example of this is the 1994 case against McDonald's Corp., in which a jury awarded a woman $2.9 million for burns suffered after spilling hot coffee in her lap. More common than tort claims are actions seeking to hold franchisors liable for the acts of franchisees under the anti-discrimination laws. In *Neff v. American Dairy Queen Corp.*, 59 F.3d 1063 (5th Cir. 1995), cert. denied, 116 S. Ct. 704 (1996), the court refused to hold the franchisor liable for a franchisee's alleged failure to make its restaurant wheelchair accessible. The court stated that in order for the franchisor to be liable under the Americans With Disabilities Act ("ADA"), it would have to be considered the "operator" of the franchise. The critical factor in making this determination is control. A review of the franchise agreement established that the franchise was to be constructed in accordance with franchisor approved standards. Further, the franchisor retained the right to set building and equipment maintenance standards and to reject proposed structural changes. However, the court held that such control was insufficient to render the franchisor the operator for the purposes of the ADA. Because of discrepancies among the circuit courts' definition of "operator" and a dearth of case law on the subject, it is too early to tell what level of risk franchisors face under the ADA for wheelchair accessibility to a franchisee's building. Until such standards become clear, franchisors should carefully consider their core policies to assess whether they are potentially discriminatory or otherwise establish excessive control over terms and conditions of employment of the franchisee's employees and customer's access to the franchisee's operation.[32] This case is explored in detail in Dickinson Law Review, Vol. 101:1, P 137. The conclusion, as expressed by the author, is that the

> ". . . ADA's provisions do not solve the question of franchisor liability for Title III. If congress does not amend the ADA and Neff becomes the guiding precedent of future Title III cases, Persons with disabilities will need to wait even longer for the equality of access their representatives promised them when the ADA was passed. Persons with disabilities can still obtain their rightful access; they just have to sue each individual store or wait until each decides to remodel. The irony is that by refusing to recognize any liability on the part of franchisors the Neff court may have disabled the ADA."

F. Disputes involving trade secrets usually test whether the franchisor owns a protectable trade secret. In other words, the question usually is whether the definitional elements of a trade secret are present, based on case or statutory law. The key issues in trade secrets involve the scope of the franchisor's know-how that is protected as a trade secret, the steps a franchisor must take to maintain secrecy, and the extent that a franchisor can enforce a covenant not to compete after the franchise ends.[33]

G. Copyright law has historically had a less significant impact on franchising in the courts. One commentator has stated that "the law of copyright is ... of tangential interest to franchise systems."[34] However, most franchise systems include original expressions which may qualify for copyright protection. Additionally, copyright law may provide greater protection for creative assets than that which trademark or trade secret law may provide.[35]

H. Patent law has also been historically less significant to franchising. If there has been a key area of patent law issues for franchising, it has been issues that arise from licensing of patents, such as whether a franchisor seeking to enforce patent rights has properly used or misused its patent, and whether a franchisee's use of a licensed patent exceeded the scope of use authorized by the franchisor.[36]

I. Franchise advertising usually gives rise to issues less frequently related to the advertising of franchises but more frequently to the misuse of advertising funds. The following case of misuse of advertising funds including a $600 million judgment was reported in the New York Law Journal (April 18, 1997). Franchise agreements entered into by Meineke with its franchisees, similar to many other franchise agreements, provided that each franchisee had to remit 10 percent of its weekly gross revenue to an advertising fund. The franchise agreements provided that these advertising contributions "shall be expended for advertising which is published, broadcast, displayed or otherwise disseminated either during the calendar year within which such funds are collected by Meineke, [or] during the immediately preceding or following calendar year." Five percent of the total advertising contribution was to be used for development and placement of national advertising; the remaining 95 percent of a franchisee's contribution was to be spent on advertising within the franchisee's locality or ADI (area of dominant influence). The court found that not only did Meineke use the profits of New Horizons for its benefit, but the court found that it used the fund to pay corporate expenses, purchase superfluous advertising for the sake of generating commissions, negotiate volume discounts from media while charging the full amount to the fund and use the fund to generate new franchisees. *Proussard v. Meineke Discount Muffler Shops, Inc.* 3:94CV 255-P (WDNC).

VIII. What is a Franchise in Law?

A. Federal and state laws, rules and/or regulations now protect prospective franchisees by requiring disclosure and registration by franchisors, and a new Uniform Franchise and Business Opportunities Act as well as a Model Law have been proposed, but problems still persist with regard to such matters as the duty of good faith, earnings claims, and the introduction of random bills attempting to correct specific problems encountered by individual franchisees. (There is also an unresolved issue concerning attorney liability for due diligence in connection with franchise offering circulars.) At the same time, there are significant economic changes, within the marketplace demanding greater levels of franchisor experience and financial strength, and the development of new forms of franchising, such as combination franchising and niche franchising.[37]

In Article 33, § 680 of the New York General Business Law, the legislative finding and declaration of policy with respect to the offer and sale of franchises is expressly set forth:

> 1. The legislature hereby finds and declares that the widespread sale of franchises is a relatively new form of business which has created numerous problems in New York. New York residents have suffered substantial losses where the franchisor or his representative has not provided full and complete information regarding the franchisor-franchisee relationship, the details of the contract between the franchisor and franchisee, the prior business experience of the franchisor, and other factors relevant to the franchise offered for sale.

2. It is hereby determined and declared that the offer and sale of franchises, as defined in this article, is a matter affected with a public interest and subject to the supervision of the state, for the purpose of providing prospective franchisees and potential franchise investors with material details of the franchise offering so that they may participate in the franchise system in a manner that may avoid detriment to the public interest and benefit the commerce and industry of the state. Further, it is the intent of this law to prohibit the sale of franchises where such sale would lead to fraud or a likelihood that the franchisor's promises would not be fulfilled.
(Added L. 1980, c. 730, § 1.)

The policy is set forth in §§ 681-695.

B. While a federal franchise relationship law of general application was proposed as early as 1971, no such law has ever been adopted at the federal level. Instead, the FTC issued its Rule on franchising, which became effective in 1979.[38] After an exhaustive study that began in 1971, the FTC determined that the most serious abuses by franchisors related to misrepresentation and failure to disclose material facts. The remedy contained in the FTC Rule is presale disclosure. The FTC Rule does not require any federal filing or registration, nor does it regulate the relationship between franchisors and franchisees after the purchase of the franchise.[39]

C. The FTC Rule imposes six different requirements in connection with the "advertising, offering, licensing, contracting, sale or other promotion" of a franchise in or affecting commerce.

1. Basic Disclosures

The FTC Rule requires franchisors to give potential investors a basic disclosure document at the earlier of the first face-to-face meeting or at least ten business days before any money is paid or an agreement is signed in connection with the investment.[40] In addition, the prospective franchisee must receive copies of all franchise and related agreements completely filled out and ready for execution at least five business days prior to the time that the franchisee executes and such contract and/or pays any money to the franchisor.

2. Advertised Claims

The FTC Rule affects only advertisements that include an earnings claim. Such ads must disclose the number and percentage of existing franchisees who have achieved the claimed results, along with cautionary language. Their use triggers required compliance with the Rule's earnings claim disclosure requirements.[41]

3. Earnings Claims

If a franchisor makes earnings claims, whether historical or forecasted, they must have a reasonable basis, and prescribed substantiating disclosures must be given to a potential investor in writing at the same time as the basic disclosures.[42]

4. Franchise Agreements

The franchisor must give investors a copy of its standard-form franchise and related agreements at the same time as the basic disclosures, and final copies intended to be executed at least 5 business days before signing.

5. Refunds

The FTC Rule requires franchisors to make refunds of deposits and initial payments to potential investors, subject to any conditions on refundability stated in the disclosure document.[44]

6. Contradictory Claims

While franchisors are free to provide investors with any promotional or other materials they wish, no written or oral claims may contradict information provided in a required disclosure.[45]

D. Failure to comply with any of the six requirements is a violation of the FTC Rule. "Franchisor" and "franchise brokers" are jointly and severally liable for the violation(s). Any person who sells a "franchise" covered by the FTC Rule is considered a Franchisor under the statute. Any person who "sells, offers for sale, or arranges for the sale," of a covered franchise is defined as a "franchise broker."[46]

Violations of the FTC Rule are an "unfair or deceptive act or practice" within the meaning of Section 5 of the Federal Trade Commission Act. The specific activities, which may give rise to a violation, include the following:

Failure to furnish prospective franchisees, within the time frames established by the Rule, with the disclosure document containing required information;

The making of any representations about the actual or potential sales, income, or profits of existing or prospective franchisees, except in the manner set forth in the FTC Rule;

The making of any claim or representation (such as in advertising or in a salesperson's oral statement) which is inconsistent with the information required to be disclosed by the FTC Rule or the UFOC Guidelines. (The FTC Rule provides, however, that franchisors and franchise brokers may supplement the disclosure documents with additional information -- orally, visually, or in separate literature -- as long as that information does not contradict the information in the disclosure documents);

Failure to furnish prospective franchisees, within the time frames established by the FTC Rule, with copies of the franchisor's standard form of franchise agreement and with the final agreement to be signed by the parties; and

Failure to provide prospective franchisees with any funds or deposits identified as refundable in the disclosure documents.

The FTC NPR Notice lists three additional prohibitions:

(i) making a financial performance representation (the proposed new term for an earnings claim) outside of the disclosure document unless certain prerequisites are satisfied;

(ii) disclaiming liability for, or causing franchisees to waive reliance on, statements made in a franchisor's disclosure documents; and

(iii) using phony references or shills to promote the sale of franchises.

The FTC can impose civil penalties of up to $10,000 per violation of the FTC Rule.[47] The FTC can also require rescission, reformation, payment of refunds or damages, or combinations of these remedies,[48] and it can issue cease-and-desist orders.

Currently, there is no private right of action for violations of the FTC Rule. Remedies do, however, exist under state law. State franchise and business opportunity laws, and state consumer fraud or "little FTC acts," which typically cover the sale of franchises and frequently make any violation of the FTC Rule a state law violation, generally provide a private right of action for rescission, damages, costs and attorneys' fees, and sometimes multiple or punitive damages.[49] Willful violations of state laws may also result in criminal penalties, including fines and imprisonment.

Sanctions under state franchise laws apply to a wide variety of conduct, such as (i) failure to register or disclose completely and accurately, (ii) failure to comply with the substantive provisions of the franchise statutes, (iii) fraud and misrepresentation in connection with the selling of franchises, (iv) failure to comply with advertising provisions, and (v) failure to comply with salesperson disclosure requirements. Sanctions apply against the franchisor and, in appropriate circumstances, persons who materially aid in actions constituting a violation, such as persons controlling the franchisor, officers and directors of the franchisor, partners in the franchisor, subfranchisors, franchise brokers and employees.

Both the state and the injured franchisee may institute actions. The state, for example, typically may bring an action for injunctive or declaratory relief, or seek civil penalties or criminal penalties consisting of fines and/or jail sentences. State administrators also may summarily issue "stop orders" or "cease and desist orders" against the further offer and/or sale of franchises.

The FTC's enforcement of its Franchise Rule has steadily accelerated throughout the past decade culminating in its significant victory in *Federal Trade Commission v. Minuteman Press, et al.*, 53 F. Sup 2d 248 (E.D.N.Y 1998).

You should beware that the FTC Franchise Rule is about to undergo a most dramatic overhaul for the first time since the regulation took effect in 1979. On October 22, 1999, the Federal Trade Commission released a "Notice of Proposed Rulemaking" (NPR") detailing such forthcoming changes.

IX. State Registration and Disclosure Laws.[50]

A. Because disclosures required by state registration and disclosure laws can be used to satisfy the requirements of the FTC Rule, it is appropriate to review the state disclosure laws in connection with the FTC Rule. Sixteen states require franchisors to register and disseminate to prospective franchisees a prospectus type disclosure document prior to engaging in any franchise sales activity. These state registration and disclosure laws provide that, unless a statutory exemption is available, no offer or sale of a franchise can take place unless and until the franchisor has filed with the appropriate state agency, and that agency has approved and registered, a prospectus setting forth honestly and in detail all of the material facts of the franchise sales transaction. This registered prospectus must then be given to prospective franchisees at the earlier of (i) the first personal meeting between a franchisor and its prospective franchisee (i.e. the first face-to-face meeting held for the purpose of discussing the sale, or possible sale, of a franchise); (ii) ten business days prior to the execution by the prospective franchisee of any franchise-related agreement; or, (iii) ten business days prior to the payment by the prospective franchisee of any monies or other consideration in connection with the sale, or proposed sale, of a franchises.[51] The most important exemption from the registration requirement is the "blue chip" exemption set forth in the CFIL section 31101, which is available to substantial franchisors who have been operating a minimum number of franchises for a specified period of time. In addition to the "blue chip" exemption in section 31101,there are other exemptions provided in the body of the Franchise Investment Law, or that have been promulgated by the Commissioner of the Department of Corporations pursuant to rule making powers of section 31100 which explicitly grant to the Commissioner the power to exempt "any other transaction which the Commissioner by rule exempts as not being comprehended within the purposes of this law and the registration of which the Commissioner finds is not necessary or appropriate in the public interest for the protection of investors." Cal. Corp. Code 31110 (West 1997). Among the exemptions set forth in the CFIL and the correlate regulations are exemptions for the sale of a franchise or area franchise by a franchisee or subfranchisor on their own account, id. 31102 (West 1997), certain transfers of franchises to persons outside the state of

California, id. 31105 (West 1997), certain offers, sales or transfers of franchises involving the wholesale distribution or marketing of petroleum products, id. 31104 (West 1997), or involving franchisees possessing certain levels of experience and sophistication, id. 31106 (West 1997), transactions relating to "bank credit card plans," id. 31103 (West 1997), transactions in which the franchise fee is no more than $100, Cal. Code Regs.tit. 310.011, or the amounts paid for fixtures, equipment and the like are no more than $ 1,000 annually, as long as those amounts are not more than comparable wholesale prices, id. 33310.011.1(West 1998). The state laws also contain significant criminal penalties. It allows district attorneys to prosecute certain violations. Section 31410 of the CFIL states that a party found guilty of a willful violation of "any provision" or of "any rule or order under", the CFIL can be fined up to $10,000, imprisoned for up to a year, or both, unless the party can establish that he or she had no knowledge of the rule or order violated.

The disclosure and registration requirements of New York are extensive, and strict compliance is required. § 687 sets forth the practices which will be found unlawful:

> 1. It is unlawful for any person to make any untrue statement of a material fact in any application, notice, statement, prospectus or report filed with the department under this article, or willfully to omit to state in any such application, notice, statement, prospectus or report any material fact which is required to be stated therein or to fail to notify the department of any material change as required by this article.
>
> 2. It is unlawful for a person, in connection with the offer, sale or purchase of any franchise, to directly or indirectly:
>
> (a) Employ any device, scheme, or artifice to defraud.
>
> (b) Make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. It is an affirmative defense to one accused of omitting to state such a material fact that said omission was not an intentional act.

(c) Engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

3. It is unlawful for any person to violate any provision of this article, or any rule of the department promulgated hereunder, or any condition to the effectiveness of the registration of an offering prospectus or of an exemption from the registration provisions of this article.

4. Any condition, stipulation, or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law, or rule promulgated hereunder, shall be void.

5. It is unlawful to require a franchisee to assent to a release, assignment, novation, waiver or estoppel which would relieve a person from any duty or liability imposed by this article.

The department of law (§ 689) is empowered to bring an action in the name of the people of the State of New York against any person concerned or in any way participating in any of the enumerated unlawful or fraudulent practices and for injunction and other relief as may be indicated.

X. Franchise Relationship Law[52]

A. Eighteen states, Puerto Rico and the District of Colombia have adopted franchise relationship laws since California passed the California Franchise Investment Law in 1971. While each state relationship law has a different definition for the term "franchise," most definitions have a combination of the following elements: (i) either a marketing plan or community of interest element; (ii) a trademark element; and (iii) a fee element.

1. Marketing Plan

The term "marketing plan" refers to a grant of the right to engage in business under a marketing plan or system prescribed in substantial part by the franchisor. Generally, a marketing plan exists whenever the franchisor presents the group of franchised outlets to the public as a unit, with the appearance of some centralized management and uniform standards. Under the California state law, 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 by the franchisor and the operation is substantially associated with the franchisor's trademark, service mark, trade name, logo, advertising or other commercial symbol and the franchisee is required to pay a franchise fee. In Illinois, the Franchise Disclosure Act provides that a marketing plan means a plan or system relating to some aspect of the conduct of a party to a contract in conducting business, including but not limited to (a) specification of price, or special pricing systems or discount plans, (b) use of particular sales or display equipment or merchandising devices, (c) use of specific sales techniques, (d) use of advertising or promotional materials or cooperation in advertising efforts. The marketing plan approach in defining what constitutes a franchise has been adopted by a majority of the states, including California, and the FTC.

2. Community of Interest

This approach has been adopted by a few states, including New Jersey and Wisconsin. Some of the franchise laws require that a franchisor and franchisee maintain a "community of interest" in the marketing of the goods or services. This is usually a much broader element than the marketing plan. In Wisconsin, for example, a community of interest exists where the parties have a continuing financial interest and a degree of interdependence.

This broad definition can refer to almost any on-going business relationship in which the dealer has an investment in the business.[54] In New Jersey, on the other hand, the courts have construed "community of interest" more narrowly and require the franchisor to maintain a higher degree of control. In effect this means that there must be a sufficient inequality between the parties such that termination of the relationship by the stronger party would shock the court's sense of equity.[55]

Under the "community of interest" approach, an agreement is considered to be a franchise where: (1) the franchisee is granted a right to engage in business using the franchisor's proprietary marks or property; (2) a community of interest exists concerning the marketing of the goods or services of the business; (3) the franchisee is required to pay a franchise fee of some sort. Due to the fact that the phrase "community of interest" is generally taken to mean simply a continuing financial interest between parties, the likelihood that a particular business arrangement might fall under such a definition is relatively strong. Therefore, "community of interest" type definitions tend to be regarded as, potentially, quite broad.

By contrast, the "marketing plan" definition provides a narrower focus. Under this approach, a business arrangement will be found to be a franchise if (1) the franchisee is granted the right to operate a business involving a marketing plan or system substantially prescribed by the franchisor; (2) the franchised business is substantially associated with the proprietary marks or property of the franchisor; and (3) the franchisee is required to pay a franchise fee of some sort.

Broken down into its component parts, the definition of franchise (marketing plan) consists of four conjoined elements: (1) the franchisee must be granted by the franchisor the right to engage in the business of offering, selling or distributing goods or services; (2) that business must be operated pursuant to a marketing plan or system prescribed in substantial part by the franchisor; (3) that business must also be substantially associated with the franchisor's proprietary marks; and (4) the franchisee must have to pay, directly or indirectly, a franchise fee.

3. Trademark

The trademark element of the state relationship laws will always be satisfied if the franchisee is licensed to do business under the franchisor's name or mark. Most of the marketing plan franchise laws, however, do not require a license. In some of these states, the operation of the franchisee's business must be substantially associated with the franchisor's trademark. In other states, the trademark element is satisfied where the franchisor's trademark or service mark identifies the goods or services sold, rather than the business itself. This would include many ordinary distributorships.[56]

4. Fee

The fee element of the definition of a franchise generally means any fee or charge that the franchisee is required to pay for the right to do business under the franchise agreement. This payment does not have to be in the form of a franchise fee; it may also be royalties on sales. As a result, almost any trademark license agreement would satisfy this requirement. It may be, for example, a required payment for rent, advertising assistance, equipment and supplies. However, it does not include payment for a reasonable quantity of goods for resale at a bonafide wholesale price.[57] For example, in *Brawley Distribution Co. v. Polaris Indus.*, the Minnesota District Court held that minimum purchase requirements, required fees for advertising and training and to process warranty work, and a charge of fifty percent over the suggested sale price did not constitute franchise fees.[58] The payment of a fee by the franchisee signals that the franchisee is buying something of value from the franchisor namely, the grant of a right to engage in a business which includes the right to use the franchisor's marketing plan, and a license to use the franchisor's commercial symbols. In this regard, then, a franchisee occupies a very different status from that of an employee, agent or other similar business entity. The franchisee, rather than being compensated by the employer or principal in exchange for services, purchases by means of the franchise fee, from the franchisor the right to own and operate his or her own business using the franchisor's business expertise and commercial symbols.

XI. The Uniform Franchise Offering Circular ("UFOC")

A. As franchising continued to expand in the 1980s as a method of doing business, litigation involving franchising also continued to increase. The result is that the rights and obligations of the parties to franchise agreements under state relationship laws and under the common law were greatly clarified. Relatively little new franchise legislation was enacted during the 1980s, although many bills were introduced during this decade both at the state and federal levels. Instead, there was a legislative reaction to the patchwork of inconsistent state legislation enacted in the 1970s. In 1983, the National Conference of Commissioners on Uniform State Law ("NCCUSL"), author of the Uniform Commercial Code ("UCC"), undertook the creation of a basis for uniformity among the state franchise laws. The NCCUSL approved the final version of the Uniform Franchise and Business Opportunities Act ("UFBOA") in 1987.[59] The Act requires a simple notice filing with the appropriate state agency in connection with franchise sales and includes a private cause of action for violation of the Act, which does not exist for violation of the FTC Rule. In the area of franchise relationships., the Act codifies the common law covenant of good faith and fair dealing, rather than mandating good cause and procedural requirements similar to those contained in a number of existing state franchise relationship laws. Passage of the Act by those states that have franchise laws would go a long way toward eliminating the inconsistencies in franchise regulation and reducing the high cost of compliance for franchisors.[60]

In order to eliminate the confusion engendered by the varying (and sometimes conflicting disclosure requirements of the different states, and to facilitate legal compliance by national or regional franchisors, the state franchise administrators originally acting under the umbrella of the North American Securities Administrators Association, or "NASAA" in the mid-1970's developed the "Uniform Franchise Offering Circular", known as the "UFOC". This UFOC, when accompanied by certain addenda and when prepared in accordance with the UFOC Guidelines promulgated by NASAA (dictating UFOC contents), will satisfy the requirements of all franchise registration states and will satisfy the Federal Trade Commission as well.

A coordinated review of a UFOC is provided that streamlines registration by franchisors filing in multiple states. It does not eliminate the filing of the required registration documents with each state but consolidates the various states comments into one unified common letter sent to the franchisor.

B. On April 25, 1993, the NASAA membership voted unanimously to adopt the New UFOC Guidelines. The phase-in adopted by NASAA provides that the New UFOC guidelines are effective six months after the FTC and each NASAA member whose jurisdiction requires presale registration of a franchise adopts the New UFOC. New York was the last state to adopt the New UFOC. As of January 1, 1996, all initial franchise applications and renewals must comply with the New UFOC.[61]

XII. Recent Administrative Developments

A. Following years of study, hearings and submissions, the FTC is about to conduct the first wholesale revision of its FTC Franchise Rule since its adoption nearly 20 years ago. In an Advance Notice of Proposed Rulemaking ("ANPR") published in the Federal Register, the FTC reveals its plans for revising the Rule and addresses a number of issues of critical concern to franchisors and franchisees alike. The FTC has no interest in applying the FTC Franchise Rule to international transactions involving American franchisors.[61] Accordingly, significant relief may be granted to franchisors when they need to comply with the FTC Franchise Rule when selling franchises abroad. At the same time, the FTC has hinted that it may impose new disclosure requirements in connection with the sale of "co-branded" franchises (in which two or more franchisors combine forces to offer a franchisee the opportunity to operate two or more trademarked franchises in one outlet). The ANPR notes that the FTC "is uncertain whether the (co-branded) franchisee is purchasing two individually trademarked franchises (and thus should receive separate disclosures from each franchisor) or is purchasing a hybrid franchise arrangement that has its own risks (and thus should receive a single unified disclosure document)."

B. Further, the FTC is exploring whether its Franchise Rule should be modified to embrace franchise sales activity taking place over the Internet and through other electronic communication modes. Similarly, the FTC -suggests in the ANPR that the "first personal meeting" language of the Franchise Rule's requirement may be replaced by a "first substantive discussion", disclosure requirement for disseminating disclosure documents. This "discussion" may -take place over the internet, the telephone or through other electronic means.

C. The most substantive potential changes are related to the mandatory disclosure requirements. The ANPR suggests that the FTC might mandate that franchisors set forth earnings claim disclosures in their disclosure documents.[63] On the other hand, the FTC appears ready to require franchisors to set forth prominently in their disclosure documents that the FTC Franchise Rule permits a franchisor to provide a prospective franchisee with earnings claim information and that if such information is not set forth in the franchisor's disclosure document, no other earnings claim information imparted should be relied upon absent written substantiation.

XIII. Antitrust

In the early 1970s, the federal antitrust laws, as then interpreted and applied by the courts, provided a powerful basis for claims against franchisors. The antitrust laws provide in many circumstances for treble damages as well as attorneys' fee awards. At that time, the legality of vertical restrictions was in doubt. In practice, many franchisors were engaging in tying practices. Many franchisees were forced to buy equipment from the franchisor or its affiliates when there were perfectly acceptable alternative sources of supply.

Key among the antitrust law's prohibitions are those prohibiting "tying". A "tying arrangement" is one in which the seller of a product (the "tying" product) conditions its sale upon the buyer's agreement to purchase a second (presumably unwanted) product (the "tied" product).

An illegal "tie" embraces the following elements: (I) there are two distinct products; (ii) the seller requires the buyer to purchase the tied (second) product in order to obtain the tying (the first and wanted) product; (iii) the seller has "market power" in the market for the tying product; and, (iv) the tying arrangement affects a substantial amount of commerce. Tying arrangements that meet these criteria are per se unlawful; tying agreements which do not meet these criteria are subject to a "rule of reason" analysis.

In the franchise arena, the judiciary early on ruled that the sale of a franchise, on the one hand, and the franchisor's sale of goods or services to its franchisees (or compelling such purchases from franchisor-approved suppliers), on the other hand, are two distinct "products" for purposes of tying analysis.

Eastman Kodak Co. v. Image Technical Services, Inc., 504 U.S. 451 (1992) ("Kodak") -- took the more reasoned approach that a franchisor's franchise is inherently indistinguishable from the products it supplies or the methods and sources it approves.

From a practical perspective, it generally mattered little whether a "franchise" could be considered distinct from the products or services which a franchisee was required to purchase from its franchisor (or from a vendor designated by the franchisor). The reason is simple. Before Kodak, the relevant market for the "tying" product, the franchise was generally held to be the market for all similar franchises. And since appreciable economic power in this market had to be demonstrated for an illegal tie to be found suggested to be at least 30% of the relevant market, few were the franchisors who had to concern themselves with "tying" issues, since few were the franchisors who accounted for 30% or more of the competitive franchise landscape.

However, the increased comfort enjoyed by franchisors as a result of the above-referenced "franchise indistinguishable from products sold" and "insufficient market power" decisions was eradicated by the U.S. Supreme Court's landmark 1992 decision in Kodak.

In Kodak, independent photocopier repair companies challenged Kodak's abrupt change of policy denying them access to Kodak parts and instead requiring Kodak customers to purchase both repair service and replacement parts from the company itself as an illegal "tie" in *per se* violation of the Sherman Act. Kodak expanded traditional antitrust "tying" analysis by concentrating not just on the primary market in question (which, in Kodak, was the market for all photocopying machines) but also on any relevant "aftermarket" (which in Kodak was deemed to be the market which Kodak photocopier purchasers confronted when seeking service and parts for their Kodak machines).

Briefly, Kodak argued that since it possessed insufficient "market power" in the primary equipment market, it could not as a matter of law exercise any market power in the aftermarket for service, even if it did have a monopoly on certain parts needed to repair Kodak machines. The U.S. Supreme Court disagreed, holding that competition in the primary market did not preclude Kodak's exercise of power in the aftermarket.

Although Kodak was only a decision denying summary judgment, it breathed new life into the argument that franchisors can possess monopoly power over their franchisees through supply relationships, the post-Kodak argument being that although a franchisor faces stiff competition in the primary market (the pre-contract market for the sale of franchises) it may nevertheless possess market power (or even monopoly power) over its franchisees in the post-contract aftermarket (the market for the sale of goods and services from franchisor to franchisees).

The question is whether Kodak applies to franchising? Do franchise agreement sourcing restrictions prohibiting franchisees from purchasing products other than from the franchisor or from franchisor-approved sources constitute an illegal "tie" or even monopolization, in violation of Sections 1 and 2 of the Sherman Act, or, in the alternative, does Kodak not apply to franchising, since the evil perceived in Kodak an unanticipated postcontractual change of policy resulting in a repair equipment/service lock-in between Kodak and its photocopier customers is not present in franchising, where sourcing restrictions are fully disclosed pre-contract both by prospectus and by the franchise agreement itself?

The answer would appear to be yes to both questions. That is, the courts are now divided over whether Kodak should or should not apply to franchising.

Franchisors seeking to severely restrict their franchisees' sources of supply of key products have to be aware of *Collins Irving Oil*, 980 F. Supp. 1252 (m.D. GA. 1997) and *Campbell v. Irving Oil Corp.* - F. Supp. - CCH Bus. Franchise Guide §11.414 MS 1998). For they are the only post-Kodak decisions to hold that Kodak applies in the franchise arena notwithstanding all logic to the contrary (franchisees, after all, receive the very detailed pre-contractual disclosure that was the "missing link" upon which the U.S. Supreme Court rested its decision in Kodak). And the Collins and Irving Oil courts, for reasons they are not disclosing, elected to ignore all of those salutary cases of the 1980's holding that non "market power" analysis applies to the franchise arena at all, since a franchise and the products which franchisees must purchase from designated sources (including the franchisor itself) are not two distinct "tying" and "tied" goods bus are, instead, part of a single integrated package.

For the time being, franchisors seeking to compete with non-franchised chains by obtaining the economies and resulting lower retail prices associated with chain wide "exclusive dealing" contracts obtained from vendors or key products find they may not do so without the possibility of great legal peril.

As a result of changes in practices in the industry and changes in the attitudes of regulatory and judicial officials toward antitrust laws, claims of antitrust violations dropped off significantly in the 1980s and 90s. Antitrust laws today are used by franchisees only in the more egregious cases.

XIV. Technology

Many franchise companies have already discovered the value of the Internet as an effective tool for promoting their systems, communicating efficiently with their franchisees and suppliers, and capitalizing on the opportunities presented by "e-commerce" - the selling of goods and services on the Internet. Other franchisors are considering their options. To exploit the immense possibilities of the Internet fully, a franchisor must first assess its goals and then decide what model for conducting website and e-commerce activities will best suit its objectives and system operations.

While each franchise network has unique or defining characteristics that will affect its Internet policies, certain issues and goals should be common to all participants. First, franchisors developing an Internet presence for their franchise network should strive to create and maintain a uniform "look and feel" for all websites associated with the network. Inconsistencies in the "look and feel" of a network's websites may damage the public's general perception of the network's uniformity, which is a hallmark of any franchise network. From a legal perspective, lack of uniformity may dilute the franchisor's trademarks, or lead to claims that content on non-franchisor controlled websites violate another party's intellectual property rights.

Second, franchise networks will benefit from using a model that allows for easy updating of the information circulated to the public via the Internet (such as seasonal promotions, product changes or franchisee information).

Third, it is important that the franchisor have a coordinated approach to the registration and maintenance of domain names; this strategy protects the entire network against both the stockpiling of valuable domain names by a rogue party and legal attacks upon the franchisor's trademarks by unlicensed users.

Fourth, coordination of Business-to-Customer ("B2C") e-commerce, both with respect to the offering of products and services and the fulfillment of customer orders, will likely be essential to the success of any e-commerce program and the long-term health of the franchise network in general. Failure to fulfill orders properly and promptly is one of the leading reasons that some e-commerce businesses have failed. In addition, such failures may prompt FTC charges that the franchisor violated the FTC Mail Order Rule (the "Mail Order Rule"). 16 C.F.R. § 435. See, e.g., U.S. Federal Trade Commission.

Fifth, franchise companies should structure the websites and webpages so that potential customers will obtain readily useable search results when searching the Internet for their franchise network or outlets. Franchisors should remember that while the Internet offers rapid access to a wealth of information, their mere presence on the Internet will not prove worthwhile unless their websites can be easily found.

Sixth, franchisors and franchisees alike should focus on delivering to the customer the best possible online presence that is consistent with the goal of presenting the best possible in-store (or in-person) experience and/or products. This goal is difficult to achieve unless the franchise company implements comprehensive web policies.

XV. Conclusion

As is clear from the foregoing paper, the concept of franchising has taken hold and exploded so exponentially that its permanency on the American landscape can no longer be questioned.

As a useful warning to practitioners counseling actual and potential franchisors and franchisees, a lesson to be learned is that a failure to properly appreciate the concept of a franchise underlying the definition in section 31005(a) of the CFIL (see also the New York General Business Law § 68 1) can result in an indiscriminate and unwarranted application of the state statutes that have adopted that statute as well as the FTC. To this end, this Article has sought to show that the concept of "franchise" encompassed by the four elements contained in the marketing definition in section 31005(a) of the CFIL embodies a specific blend of independence and dependence.

A franchise is a relationship in which the franchisee is independent by virtue of the fact that the franchisee is granted the right by the franchisor to actually own and operate the franchise business. As a result, the franchisee is the one who actually runs the business and bears the risk if it is not successful. At the same time, the franchisee is singularly dependent upon the franchisor due to the fact that the success of the business largely depends upon the franchisor's expertise, in the form of the method of operation provided by the franchisor, and the franchisor's commercial identity, in the form of the franchisor's symbols. Indeed, it is the grant of the right to engage in business using the franchisor's method of operation and commercial symbols for which a franchisee pays a franchise fee. Without this unique blend of independence and dependence, there simply is not a franchise. Absent an appreciation of the conceptual basis of the definition of "franchise", the courts may well continue improperly to transform into franchises traditional forms of business enterprises, which do not, in fact, possess the necessary blend of independence and dependence.

ENDNOTES

[1] David J. Kaufmann, *An Introduction to Franchising and Franchise Law, Franchising 1992, Business and Legal Issues,* 12 Practicing Law Institute Commercial Law and Practice Course Handbook Series 603 (1992).

[2] Harold Brown, *Franchising, Realities and Remedies,* § 1.03[l] (Law Journal Seminars-Press 1997). Martin D. Fern, *The Overbroad Scope of Franchise Regulation: A Definitional Dilemma,* 3rd Bus. Law. 1387 (1979).

[3] This definition was devised by commentator Harold Brown and was substantially adopted in a number of states.
Connecticut: Conn. Gen. Stat. Ann § 42-133e(b).

New Jersey: N.J. Stat. Ann. § 35.6-1.

Washington: Wash. Rev. Code § 252. 1.

[4] Brown, *supra* at § 103[3].
[5] Kaufmann, *supra* at 12.
[6] Kaufmann, *supra* at 13.
[7] "Franchising in the Economy 1986-87," U.S. Dept. of Commerce 1988 *cited in* Brown, *supra* at § 1.01[1]. S. J. Kelly, Small Business Forum; *Is Your Future In Franchises? Assess the Opportunity and Risk,* L.A. Times, June 3, 1998, at D7. International Franchise Association, Industry and Trade Summary on Franchising (1995).
[8] Brown, *supra* at § 1.02[2].
[9] Kaufmann, *supra* at 19.
[10] Brown, *supra* at § 1.02[2].
[11] Brown, *supra* at § 1.02[2].
[12] Brown, *supra* at § 1.02[3].
[13] Brown, *supra* at § 1.02[l].
[14] Brown, *supra* at § 1.02[2]
[15] Brown, *supra* at § 3.02[l]
[16] Kaufmann, *supra* at 24.
[17] Kaufmann *supra* at 26.
[18] Kaufmann, *supra* at 27.
[19] Kaufmann, *supra* at 27.
[20] Kaufmann, *supra* at 29.
[21] Lowell, *Sources and Trends for Franchise Law in the Eighties (Part 3),* 2 Franchise L.J. 30, Spring 1983; Leet, *Sources and Trends for Franchise Law in the Eighties (Part 4),* 5 Franchise L.J. 15, Fall 1985; Lowell, *Time Travel: Franchise Relationships of Tomorrow,* American Bar -Association 11th Annual Forum on Franchising (1988). Cited in 62B Am. Jur. 2d Private Franchise Contracts § 6 (1990).
[22] David Gurnick, *A Symposium on Franchise Law: Intellectual Property in Franchising: A Survey of Today's Domestic Issues,* 20 Okla. City U.L. Rev. 347 (1995).

23 Gurnick, *supra* at 351.

24 See e.g., *Susser v. Carvel Corp.*, 206 F. Supp. 636, 640 (S.D.N.Y. 1962), *affd.* 332 F.2d 505 (2d Cir. 1964), cert. dismissed, 381 U.S. 125 (1965) (stating that the trademark is the cornerstone of a franchise system. See also 2 J. Thomas McCarthy, *McCarthy on Trademarks and Unfair Competition* §18.22 (3d ed. 1992) ("In some situations, a franchise is merely a sophisticated program of trademark licensing.") cited in David Gumick, A Symposium on Franchise Law: Article: *Intellectual Property in Franchising: Survey of Today's Domestic Issues,* 20 Okla. City U.L. Rev. 347, *351.

25 Franchised automobile and truck dealers, gasoline service stations, and soft drink bottlers together accounted for an estimated 70% of all sales by franchises in the U.S. in 1988. Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors,* 45 Bus. Law.

26 15 U.S.C. §§ 1055, 1064(e)(1), 1127.

27 15 U.S.C.§ 115(b)(7).

28 See also *Mariniello v. Shell Oil Co.,* 511 F.2d 853 (3rd Cir. 1975).

29 *Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.,* 732 F.2d 480 (5th Cir. 1984); *Bain v. Champlin Petroleum Co.,* 692 F.2d 43 (8th Cir. 1982); *Arnott v. American Oil Co.,* 609 F.2d 873 (8th Cir. 1979), *cert. denied* 446 U.S. 918 (1980).

30 Gurnick, *supra* at 353.

31 See, e.g. "McDonald's Settles Out of Court Over Coffee Burns," *Leg. Intelligencer*, Dec. 5, 1994, at 4. A judge later reduced the award by more than $2 million. Ultimately, the case was settled for an undisclosed amount. *Id.*

32 Jeffrey S. Klein and Nicholas J. Pappas, *A Franchisor's Liability For Discrimination by Franchisees,* 6/3/96 N.Y.L.J. 3, (col. 1).

33 Gurnick, *supra* at 352.

34 W. Michael Garner, *Franchise and Distribution Law and Practice* § 7.47 (1990).

35 Gurnick, *supra* at 353.

36 *See e.g.* Span-Deck, Inc. V. Fab-Con, Inc. 677 F.2d 1237 (8th Cir. 1982), *cert. denied,* 459 U.S. 981 (1982); *R & G Affiliates, Inc. v. Knoll Intl.,* Bus. Franchise Guide (CCH) ¶ 8181 (S.D.N.Y. 1984).

37 62B Am. Jur. 2d, *supra.*

38 Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. 436 (1979).

39 Pitegoff, *supra* at *4.

40 Lydia B. Parries, Federal Trade Commission Regulation of Franchising, 12 Practicing Law Institute Commercial Law and Practice Course Handbook Series 603, 102 (1982).

41 Parnes, *id.*

42 Parnes, *id.*

43 Parnes, *id.*

44 Parnes, *id.*

45 Parnes, *id.*

46 Lydia D. Parries, *Federal Trade Commission Regulation of Franchising*, 12 Practicing Law Institute Commercial Law and Practice Course Handbook Series 603, 102 (1982).

47 15 U.S.C. § 45(m)(1).

48 15 U.S.C § 57(b).

49 *Selliner v. Freeway Mobile Homes Sales, Inc.,* 110 Ariz. 573,521 P. 2d 1119 (1974).

50 STATE FRANCHISE DISCLOSURE LAW CITATIONS

California: Cal. Corp. Code, Ch. 10 §§ 310 *et seq.*

Florida: Fla. Stat. Ann., Ch. 71-61; see also Florida Rules, Ch. 2-17.

Hawaii: Hawaii Rev. L. § 482E-1.

Illinois: Ill. Ann. Stat., Ch. 121, § 701

Indiana: Ind. Code § 2.5.23-1.

Massachusetts: Mass. Gen. L. Ann., Ch. 93A § 2(a), (b).

Michigan: Mich. Comp. L. § 19.854, later amended to prescribe disclosure without prior registration.

Minnesota: Minn. Stat. Ann. § 800.01.

New York: N.Y. Gen. Bus. L. §§ 680-695.

North Dakota: Senate Bill No. 2479 (1975)..

Oregon: Ore. Rev. Stat. § 650.007; see also, Oregon Rule § 40-050.

Rhode Island: R.I. Rev. L. Ann. § 19-28-1.

South Dakota: S.D. Comp. L. § 37-5A-1.

Virginia: Va. Code Ann. § 13.1-557.

Washington: Wash. Rev. Code § 19.100.010.

Wisconsin: Wis. Stat. Ann. § 553.10; see also, Wis. Adm. Code § 31.01.

51 Kaufman, *supra* at 50.

52 FRANCHISE RELATIONSHIP LAW CITATIONS AND POPULAR NAMES
Franchise Practices Act, Ark. Stat. Ann. §§4-72-201 to -210 (1987).

California Franchise Relations Act, Cal. Bus. & Prof. Code § § 20000 to 20043 (West 1981).
Trading Stamps, Mail Order, Franchises, Credit Programs, Subscriptions Act, Conn. Gen.

Stat Ann. §§ 42-133e to -133h (1972).

Delaware Franchise Security Law, Del. Code Ann. tit. 6 §§ 2551 to 2556 (1953).

Franchising Act., D.C. Code Ann. §§ 29-1201 to -1208 (1989).

Franchise Investment Act, Hawaii Rev. Stat. § 482-E6 (1978).

Franchise Disclosure Act, Ill. Rev. Stat, ch. 121 1/2 ¶ 1718-20 (1988).

Deceptive Franchise Practices Act, Ind. Code Ann. § 23-2-2.7-1 (1987).

Franchise Investment Law Act, Mich. Comp. Laws § 445.1527 (West 1984).

Franchise Act, Minn. Stat. § 80C.14 (1986).

Pyramid Sales Scheme Act, Miss. Code Ann. § 75-24-53 (1975).

Pyramid Sales Scheme Act., Mo. Rev. Stat. §§ 407.400 to .420 (1975).

Franchise Practices Act, Neb. Rev. Stat. §§ 87-401 to -410 (1978).

Franchise Practices Act, N.J. Rev. Stat. §§ 56:10-1 to :10-12 (1971).

Retail Franchising Act, Va. Code Ann. § 13.1-557 (1972).

Franchise Investment Protection Act, Wash. Rev. Code §§ 19.100.180, .190 (1980).

Fair Dealership Law, Wis. Stat. §§ 135.01 to .07 (1985).

Dealer's Act P.R. Laws Ann. tit. 10, § 14-278 (1964).

V.I. Code Ann. tit 12A § § 2-130 to - 139 (1979).

[53] The California Franchise Investment Law requires franchisors to register and disseminate to prospective franchisees a prospectus-type disclosure document prior to engaging in any franchise sales activity. California Corporations Code, Div. 5, Parts 1-6, Sections 3100 *et seq*.

[54] Wis. Stat § 135.02(3) (1985).

[55] *New Jersey Am., Inc. v. The Allied Corp.,* Bus. Franchise Guide (CCH) P9395 (3d Cir. 1989); *Colt Indus. v. Fidelco Pump & Compressor Corp.,* Bus. Franchise Guide (CCH) P9095 (3rd Cir. 1988).

[56] For discussions of the trademark requirement, see *Colt Indus*., Bus. Franchise Guide (CCH) P9095 (New Jersey); *American Business Interiors, Inc. v. Haworth, Inc.,* 798 F.2d 1135, 1140 (8th Cir. 1988).

[57] Cases discussing the fee requirement include *inter alia Boat & MotorMart v. Sea Ray Boats, Inc.,* 825 F. 2d 1285 (9th Cir. 1987) (California Law); *Cambee's Furniture v. Doughboy Recreational*, 825 F. 2d 167 (8th Cir. 1987) (South Dakota law); *Inland Printing Co. v. A.B. Dick Co.,* Bus. Franchise Guide (CCH) P8997 (W.D. Mo. 1987) (Illinois law); *American Parts System v. T & T Automotive,* 358 N. W. 2d 674 (Minn. Ct. App. 1984) Minnesota law).

[58] Pitegoff, *supra* at *8.

[59] Bus. Franchise Guide (CCH) P3600 [hereinafter Act].

[60] Pitegoff, *supra* at *5.

61 Bus. Franchise Guide (CCH § 5901).

62 "The Rule Review record strongly supports modification of the Rule to clarify that international franchise sales are not within its purview."

63 "The Rule Review record ... does not support the view that a franchisor's failure to provide earnings information is necessarily deceptive or unfair ... [The] record indicates that prospective franchisees can obtain earnings information from other sources .... Moreover, the ... record does not provide a sufficient basis for the Commission to formulate an earnings disclosure that would be both useful and not misleading to prospective franchisees."

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