Do you have a client that is unknowingly operating a franchise system? If the client is licensing others to use its trade name or trademarks for a fee, the answer could be yes. The fact is that under federal law, a commercial relationship between two parties may be a franchise—even if neither of the parties intended to create one.

The purpose of this article is to help business counsel to identify situations in which a client may be operating an unintended franchise. The article also provides some basic information regarding the federal laws and regulations that apply to franchise companies, and identifies some exclusions and exemptions that may be available to business owners under those laws.

Regulatory landscape

Although franchising traces its roots back as far as the 1850s, franchising first became common as a business model in the middle of the twentieth century. The establishment of the interstate highway system led to a perceived need by travelers for consistent, reliable experiences on the road with familiar brands. During the 50s and 60s, restaurant and motel companies rushed to meet these needs, and franchise companies like Holiday Inn, McDonald’s, and Howard Johnson’s became some of the most recognizable names in the country.

The boom in franchising also led to a proliferation of complaints about franchise operators and their business practices. Congress began to hear from individual franchise owners who claimed that franchise companies were acting wrongfully through the use of fraud, improper terminations and other unfair conduct. To respond to this growing problem, Congress passed a law empowering the Federal Trade Commission (“FTC”) to administer and regulate franchising. See 16 C.F.R. § 436 (1979). This law is known as the “Franchise Rule.”

Under the Franchise Rule, any person or corporation that sells franchises within the United States is obligated to provide its prospective franchisees with a disclosure document, known as the Franchise Disclosure Document (“FDD”). The FDD (which was previously known as the Uniform Franchise Offering Circular) must contain information regarding the company, the business being franchised and the franchise relationship. The specific types of information that must be furnished are identified by the Franchise Rule, and cover issues like the franchisor’s past history of litigation, the basis for its earnings claims and a description of all fees that must be paid to the franchise company.

The Franchise Rule makes it “an unfair or deceptive act or practice” for a franchise company to fail to provide a FDD to a prospective franchisee. The FTC has exclusive jurisdiction to enforce violations of the Franchise Rule, and penalties can be stiff—including injunctions, asset freezes, and monetary penalties up to $11,000 per violation. There is no private right of action under the Franchise Rule, but there is no limitation on an individual franchisee’s right to sue under common-law theories (such as fraudulent inducement) based on disclosures made by the franchise company in the FDD.

Regulatory compliance for franchise companies does not end with the Franchise Rule. Many states have also adopted laws that apply directly to franchise companies. Typically, these state laws will require disclosures above and beyond those identified in the Franchise Rule, may require pre-registration with state officials before a franchise sale can be made within the state and may govern certain aspects of the relationship between the franchisee and franchisor. And, unlike the Franchise Rule, most franchise-specific state laws do provide the franchisee with a private right of action against the franchisor.

Nevada does not have any laws that are specific to franchising. However, because even businesses that are located entirely in Nevada are subject to the Franchise Rule, the Nevada attorney needs to be aware of the factors that will make a business a “franchise” within the meaning of the Franchise Rule.

“Franchise” as defined by the Franchise Rule

Generally, the term “franchise” refers to a continuing commercial relationship wherein a “franchisor” licenses to a “franchisee” the right to use a trademark and a method of
doing business or system of operation in exchange for a fee. Under the Franchise Rule, a “franchise” is a business that is characterized by the following definitional elements:

1. Trademark. The business involves the distribution of goods or services associated with the franchisor’s trademark or trade name;
2. Fee. The franchisor requires payment by the franchisee of at least $500 within six months of signing of an agreement; and
3. Control or Assistance. The franchisor exercises significant control over, or provides significant assistance in, the franchisee’s method of operation.

16 C.F.R. § 436.2(a). A “franchisor,” in turn, is defined as a person who sells a “franchise.” Id. at § 436.2(c).

Determining whether a specific business arrangement is actually a franchise is not always easy. While the presence or absence of a license to use a trademark can be an initial “bright line” test, the question of whether the other two elements are met can be more tricky. For example, courts have found that the “fee” element may be present where a distributor is required to purchase supplies or inventory from the licensor (Ward Enterprises, Inc. v. Bang & Olufsen America, 2003 WL 22859793 (N.D. Ill. 2003)) or where the licensee is found to have made an “unrecoverable investment” in the business (see, e.g., Atchley v. Pepperidge Farm, Inc., 2005 WL 1213959 (E.D. Wash. 2005)).

Similarly, whether the control or assistance of a putative franchisor is “significant” is a fact-specific inquiry. According to the FTC, “‘significance’ is a ‘function of the degree of reliance which franchisees are reasonably likely to place upon the controls or assistance.” See Statement of Basis and Purpose, 43 Fed. Reg. 59,614, 59,700 (Dec. 21, 1978).

The Franchise Rule also contains two key exemptions. First, it exempts a licensing arrangement that “is the only one of its general nature and type to be granted by the licensor with respect to that [mark].” 16 C.F.R. § 436.2(a)(4)(iv). Similarly, the Franchise Rule exempts a “fractional franchise,” where: (i) the franchisee has been in the same type of business for at least two years, and (ii) sales from the franchise would represent no more than 20 percent of the franchisee’s sales in dollar volume. Id., at §§ 436.2(a)(3)(i), 436.2(h).

**Tips for counsel**

As implied by the title of this article, a business arrangement can be a franchise regardless of the parties’ intentions. If the relationship meets all of the key definitional elements, no amount of disclaimers or waivers can avoid the applicability of the Franchise Rule. As a result, business arrangements that ostensibly may not appear to be franchises—like partnerships, joint ventures, leases, and distributorships—have in certain circumstances been found to actually be franchises.

In many instances, the Franchise Rule can be avoided from the outset if the parties are aware of the key badges of franchising discussed above, and structure their relationship so that at least one of the elements does not apply. Where a franchise relationship is already in existence, however, it is important to identify that status so that remedial measures can be taken; the consequences for doing nothing can be severe.

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