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M E M O R A N D U M

TO: Clients and Friends of the Firm

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SUBJECT: Franchising Overview[1]

1. Introduction.

Franchising is a huge and growing part of the nation's economy. More than 300,000 franchised small businesses operating in the United States account for an estimated $1 trillion worth of income each year and provide jobs for some eight million Americans. Franchising has also entered the Internet era.

All too often since California enacted the first franchise law in 1971, a company that is not a "franchisor" in the traditional sense has discovered that its way of doing business, its methods of distributing products or services or its grant of "licenses" of one type or another brings it within the extraordinarily broad scope of federal and state franchise laws. This "discovery" usually takes place in the context of a governmental investigation or prosecution, sometimes accompanied by private lawsuits by putative franchisees unhappy with the business relationship.

Most business people are oblivious that federal and state franchise laws extend beyond traditional franchisors, such as those engaged in the fast food, hotel/motel and convenience store sectors of the economy. They are unaware that franchise laws generally define the terms "franchise" and "franchisor" so broadly as to embrace innumerable businesses, business relationships, licenses and distribution methods that seem to have nothing to do with traditional franchising.

2. What is a "Franchise"? A General Overview.

1 **This memorandum is not intended to provide legal advice on a particular matter. Its sole purpose is to provide general information and education on the subject. If you are contemplating a specific transaction or matter, you are encouraged to seek legal advice for your particular transaction. For more information, please call Stanley B. Kay at (617) 928-3677.**

"Franchising" may mean different things to different people, but the applicable definition is a product of federal and state statutory law, and, in some case, court decisions. On the federal level, the Federal Trade Commission Franchise Rule ("FTC Rule") governs the offer and sale of franchises. Fifteen states have laws governing the offer and sale of franchises and requiring registration and/or disclosure of franchise offerings, much as in the securities arena. Eighteen states (including some of the registration/disclosure states) and the District of Columbia have laws governing the franchisor-franchisee relationship, addressing such issues as when the termination of franchise agreements is lawful, when franchise agreements must be renewed and what competition by the franchisor or another franchisee constitutes unlawful "encroachment" upon an existing franchised business.

Generally speaking, however, this mix of federal and state laws define a franchise as an agreement between a franchisor and franchisee that typically contains the following elements:

- The transfer of products, know-how, and proprietary information developed by the franchisor, either as a product to be distributed by the franchisee or as a business format to be followed by the franchisee, that enables the franchisee to start its own business.
- The licensing of trademarks or service marks owned by the franchisor that carry with them public acceptance and good will.
- Exercise of a significant degree of control by the franchisor over the manner and method in which the franchisee conducts its business.
- Continuing payments by the franchisee to the franchisor, usually in the form of an initial fee, and subsequent continuing royalties based on the franchisee's sales.

Notwithstanding this generalization, however, a lawyer will have to consult the federal law, and all applicable state laws which may effect the franchise or distribution relationship. The discussion below deals principally with the FTC definition, which is usually used as a "default" definition, unless a more comprehensive state law applies.

3. FTC Rule definition of "franchise."

The FTC Rule covers two types of continuing commercial relationships. Each is treated by the Rule as a "franchise," but they are separately defined as "product and package franchises" and "business opportunity ventures."

In product franchises, the franchisee distributes goods that are produced by the franchisor (or under its control or direction) and bear the franchisor’s trademark. The franchisee is required to pay the franchisor for the right to sell the trademarked goods, either by required purchases of equipment, supplies, and so forth, or by paying an initial fee for the right to sell the goods. Examples of product franchises are automobile and gasoline station dealerships.
A package franchise, sometimes called a "business format franchise," is one of the traditionally

well known franchises. Under this approach to franchising, the franchisee adopts a business format established by the franchisor and identified by the franchisor's trademark. In order to be treated as franchise subject to the FTC Rule, the franchisee is required to pay the franchisor, or its affiliate, at least $500 within the first six months of the franchise. The franchisee's method of operation in producing the goods or services that are sold is subject to significant control instituted by the franchisor, or, alternatively, the franchisor promises to render significant assistance to the franchisee in the operation of the business. Examples of package franchises include fast-food outlets, travel agencies, and real estate brokerages.

The second major category of franchise under the FTC Rule, the business opportunity venture, is covered by the Rule if each of the following three elements is present:

- The franchisee sells goods or services supplied by the franchisor or other suppliers, either designated by or affiliated with the franchisor.
- The franchisor secures retail outlets or accounts for the goods or secures locations for vending devices or racks.
- The franchisee is required to pay the franchisor, or its affiliate, at least $500 within the first six months of the franchise.

The most common types of business opportunity ventures are rack job and vending machine routes. In these ventures, the franchisor puts the franchisee into a business of distributing certain goods or services, usually those of a well-known third party, by providing or suggesting a supplier of the goods and by representing that the franchisor will establish retail accounts or place vending machines or rack displays in suitable locations.

Note that the FTC Rule includes within the definition of the term "franchise" any relationship that is represented as being a franchise when that relationship is entered into regardless of whether, in fact, the relationship falls within the FTC Rule's definition of the term.

4. Relationship between the FTC Rule and state law

While the FTC Rule provides a minimum national standard for franchise disclosure, a number of states provide their own franchise regulations and, in some instances, require registration of a franchise offering. The manner in which the FTC Rule works in conjunction with these state laws is the subject of frequent debate and confusion.

Generally speaking, however, the FTC Rule will apply as the minimum standard for purposes of disclosure unless a state requires stronger regulation or additional protection. Thus, if a state requires registration and additional items of disclosure, then for purposes of those issues, the state's law would preempt or override the minimum FTC requirement.

Most state registration laws permit the use of the FTC disclosure document when offering franchises in the registration state. These states require the document to be registered with a state agency such as the Attorney General, Secretary of State, or special franchise administrator. Notwithstanding this, however, because some registration states prefer the Uniform Franchise Offering Circular (UFOC) format, the UFOC disclosure document has become the format of choice.

5. Filings.

Unlike securities laws, franchise-related statutes are not designed to be “Blue Sky” laws; instead, their purpose is to provide prospective franchisees with information that can help them determine whether they should purchase a particular franchise. In some states, however, the laws analyze a franchisor’s financial statements and franchise agreements and make value judgments about them. If these documents do not meet the requirements of some state agencies, “Risk Factor” notices, escrow requirements and bonding requirements may be imposed or the agencies may even refuse to register a franchise.

Originally, franchisors had to use documents drafted according to the requirements of the Federal Trade Commission Disclosure Rule. This created a situation that required different versions of the franchise disclosure document to comply with different state disclosure requirements. To allow franchisors to use the same document on a nationwide basis, a Uniform Franchise Offering Circular (“UFOC”) was developed and has since been amended by the Midwest Securities Commissioners Association and its successor, the North American Securities Administrators Association (“NASAA”). The Federal Trade Commission issued a franchise disclosure rule in 1978 allowing franchisors the option to use the UFOC in lieu of its document. For this reason, most franchisors now use the UFOC.

6. Using the UFOC.

Although the states have different disclosure requirements, in some cases a franchisor can use one UFOC nationwide by adopting state-specific language internally in the UFOC and addenda to the disclosure section and the franchise agreement. Nevertheless, some states have contradictory disclosure rules that result in the need for a state-specific UFOC.

The UFOC generally contains a federal cover page, a state-specific cover page (with different language depending on the state), a table of contents (listing the 23 required items that are sections of the UFOC, followed by a list of exhibits in the UFOC), the disclosures for the 23 required items, financial statements (audited financial statements for the past three fiscal years, with unaudited financial statements that are within 90 days of the filing of the UFOC, if necessary), copies of all agreements that the franchisee must execute, and a receipt page for the UFOC.

Additional documents may have to be filed to register a franchisor to sell in a state.

In certain circumstances, state registration is not necessary. Some states do not require registration if a franchisor has a federally registered trademark or service mark and provides a UFOC to prospective franchisees, or if a franchisor has a certain specified amount of net worth, or an offer is made to a maximum of two persons, or an offer is made to an existing franchisee.

7. Registering the Franchise

To offer to sell a franchise in or from a particular state, a franchisor may have to first be registered. This applies when an offer to sell a franchise is made in that state, when an offer to buy is accepted in that state, when the franchisee is domiciled in that state, or when the franchised business is or will be operated in that state. An offer to sell is made in that state when the offer either originated from that state or is directed by the offeror to that state and is received at the place where it is directed. An offer to sell is accepted in that state when acceptance is communicated to the offeror from that state. Effectively this means that if a franchisor is located in that state it must register in that state to sell franchises either within or without that state.

If a franchisor wishes to advertise, many states require that the advertisement first be filed with the state. Many states also require that reports be filed on sales. The federal rule requires that a UFOC be given at least five business days before the date that agreements are to be executed, but many states require that the UFOC be given to the franchisee earlier.

8. Final Comments.

This brief memo cannot adequately discuss all of the issues and requirements that may apply to a particular franchise. From a legal point of view, franchising is governed by a web of federal and state laws, some of which may overlap with or preempt others. If you are contemplating the franchise of a product or service, you should carefully assess these legal requirements in consultation with your lawyer.

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