Wolves in Sheep's Clothing: "Accidental" Franchises May Have Teeth

By Charles S. Modell

Written for traditional franchises, the franchise laws in fact cover a variety of business relationships that you may not think of as franchises. Understanding the broad definition of a franchise and business opportunity under these laws is critical if you are to avoid liability for failing to identify the "accidental franchise."

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Remember that license agreement you drafted last week? Or the dealership agreement? How certain are you that the relationship you created did not fall within the definition of a franchise under state or federal law? Would your confidence level change if you knew that the wrong answer could result in everyone with whom your client has done business being entitled to rescind their transaction, and your client convicted of a felony?

Many well-meaning attorneys have tried to avoid application of the franchise laws by referring to a relationship as a "license" and not a franchise, or to the agreement as a "license agreement," "dealer agreement," or "consulting agreement" when, in fact, the agreement, and their client, was subject to regulation under state and federal franchise laws. To paraphrase an old saying, if it walks like a duck, quacks like a duck, and swims like a duck, call it what you want, but you may be guilty of malpractice.

Elements of a Franchise

If a relationship contains three specific elements, it is a franchise. The

Federal Trade Commission's "Disclosure Requirements and Prohibitions Concerning Franchising," 16 C.F.R. pt. 436 (2008), also known as the FTC Franchise Rule, defines a franchise as "any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that: (1) the franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services or commodities that are identified or associated with the franchisor's trademark; (2) the franchisor will exert or have authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and (3) as a condition of obtaining or commencing operating of their franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate [within the first six months]."

Any relationship that falls within the definition of a franchise will also be subject to laws in a number of states, including Minnesota, that govern the relationship, including the manner in which the relationship can be terminated.

With a few exceptions, the state law definitions are similar. Thus, an analysis of any relationship begins with a look at whether the elements listed in the FTC Franchise Rule are present.

1. Identification with the Franchisor's Trademark. It is not necessary that the putative franchisee operate as "McDonald's," "Hilton," or any other name owned by the franchisor, to satisfy the trademark element. This element is satisfied if the trademark is used in the business:

- If the licensee identifies its business by its own name, but there is a logo, tag line, or other indicator that the business is an affiliate of, or associated with the "xyz network," the trademark element is met.
- If the dealer sells goods or services bearing a trademark, the trademark element is met.[1] Thus, when Best Buy sells appliances identified or associated with the General Electric trademark, this element of the test is met.
- In Minnesota, even when the putative franchisor's trademark is not used, if the franchisee has the right to use the grantor's "advertising, or other commercial symbol or related characteristics," the trademark element is satisfied.[2]
- Even if the agreement does not "require" use of a mark, the licensee's permissive use of the licensor's mark to identify its business is sufficient to satisfy the trademark element.[3]

Any trademark license agreement, by its very nature, meets this first element of the test since there is a trademark licensed by one party to the other. Likewise, any distributorship or dealership that permits the dealer to sell products bearing the seller's trademark will meet this element of the test. To avoid being a franchise, these relationships will therefore need to "miss" one of the other elements.[4]

2. Payment of a Franchise Fee. The definition of a franchise fee is very broad. Almost any upfront payment, whether for the right to do business, or for a territory, or for a turnkey package constitutes a franchise fee. Most ongoing payments, whether a fixed fee (such as a fixed monthly license fee) or a percentage of sales, are also "franchise fees." The Minnesota Franchises Act (the "act") defines a "franchise fee" as "any fee or charge … including, but not limited to, the payment either in lump sum or by installments of any initial capital investment fee, any fee or charges based upon a percentage of goods or net sales whether or not referred to as royalties, any payment for goods or services, or any training fees or training school fees or charges … ."[5]

Fees paid to third parties, such as fees to airlines and hotels for travel expenses related to training or other ordinary business expenses, do not constitute franchise fees under state or federal law. Thus, in *Schultz v. Onan Corp.*, 737 F.2d 339 (3d Cir. 1984), the court found that fees incurred to attend training and money paid to acquire a distributorship from a predecessor were not franchise fees since they were payments to a third party. However, for fees paid to the putative franchisor, there are very few exceptions.

One exception is for the purchase or lease, at fair market value, of real property.[6] Thus, even though the retailers in the Mall of America may use the MOA logo in their advertising, there is not a franchise relationship with the mall owner because the only fees paid to the landlord are for the lease of the real estate. The most typical exception is for the purchase of goods or agreement to purchase goods at a bona fide wholesale price.[7] General retailers that sell trademarked products usually do not pay anything for the right to sell those appliances. Rather, they pay

only the bona fide wholesale price of goods for resale. As a result, the Best Buy GE relationship discussed above is not a franchise, because Best Buy does not pay General Electric a franchise fee.

Unhappy dealers have still asked the courts to look more closely at the question of whether the price paid for goods includes a "hidden" franchise fee. Thus, when a manufacturer "front loads" its dealers by imposing a minimum initial purchase requirement, the payment for inventory may be a franchise fee if the dealers must purchase amounts or items in excess of that which a reasonable businessperson, without such a requirement, would choose to purchase to start or continue a business.[8]

Most attempts on the part of dealers to claim that the price of goods represented an indirect franchise fee have failed. Most recently, in *Coyne's and Co., Inc. v. Enesco, LLC*, 565 F. Supp. 2d 1027 (D. Minn. 2008), *aff'd*, 553 F.3d 1128 (8th Cir. 2009), a Minnesota dealer argued that a markup of 30-50 percent over the manufacturer's cost of products constituted a hidden franchise fee. Coyne's argued that it was simply illogical to assume that all of the rights granted to Coyne's under the agreement, such as the right to use the trademarks and the grant of a territory, were granted in consideration for the payment of a bona fide wholesale price for these products. The district court disagreed, concluding that the product markup was not an indirect franchise fee, but simply a reasonable wholesale mark-up allowed to the manufacturer on the sale of products.

A 2008 federal district court case suggested that certain other payables, not specifically excluded under the statute, might also be excluded from the franchise fee definition. In *Day Distributing Co. v. Nantucket Allserve, Inc.*, No. 07-CV-1132 (PJS/RLE), 2008 WL 2945442 (D. Minn. July 15, 2008), a beverage dealer alleged that cooperative advertising and marketing fees constituted franchise fees within the meaning of the act. The court held that, even though these fees were required to be paid to the manufacturer, they represented ordinary business expenses that were reasonable in amount, and had a valid business purpose. Thus, the court held that the fees did not constitute franchise fees under the act. However, practitioners should be careful about including such additional fees in license and dealer agreements. A few years earlier, in *Pool Concepts, Inc. v. Watkins, Inc.*, Bus. Franchise Guide (CCH) ¶12,249 (D. Minn. 2002), this same federal district court found that when the wholesale price of goods included payments that were transferred by the manufacturer into a co-op advertising fund, the portion of the purchase price that was transferred to the advertising fund was a payment not excluded by the act, and thus was a franchise fee within the meaning of the act.

It is not possible to reconcile the *Coyne's and Day Distributing* cases with the *Watkins* case. In *Watkins*, the court looked at whether the wholesale price of goods covered other items, while the court in *Coyne's* ended its inquiry after determining the product purchase price was reasonable. In *Day Distributing*, the court found that cooperative advertising payments, the very type of payments that *Watkins* held were franchise fees, were merely ordinary business expenses and therefore were not franchise fees under the act. Thus, perhaps *Watkins* has been overruled. However, while that argument should be advanced to defend an agreement that is challenged as a franchise agreement, it may not be prudent for practitioners who draft these agreements to ignore the literal language of the act (which does not exempt ordinary business expenses from within the definition of a franchise fee) or to rely exclusively on *Day Distributing*. Further, *Day Distributing* would likely have been decided differently in other states. In Minnesota, the purchase of supplies or fixtures necessary to enter into the business or to continue in business is an exception to the franchise fee element.[9] The court in *Day Distributing* noted this exception, and analogized the payment for co-op advertising to payments for necessary supplies. That exception, however, does not exist under federal law or under the laws of many of the other states that regulate franchises.

Many dealer arrangements will not be franchises because the only fees paid to the manufacturer are for the purchase of goods at wholesale. However, there are very few ways to avoid the fee element when your client licenses a trademark but does not sell goods to the licensee. In these cases, the focus will be on the third element of the definition.

3. The Third Element. Under the FTC Franchise Rule, the third element involves either "control or assistance" on the part of the putative franchisor. Training programs, operating manuals, sales assistance, and the like are all sufficient assistance to meet this element.[10] Thus, any time your client is offering a license arrangement that includes the provision of assistance in connection with the operation or promotion of the business, this element will be met.

That is not to say that you cannot create a true "license" arrangement that is not a franchise. Take, for example, a license from the Minnesota Twins to a clothing manufacturer that produces products bearing the Twins name and logo. The Twins grant the licensee the right to place their trademark on goods the licensee will sell, and the licensee pays a license fee to the Twins (typically a percentage of its sales). However, the Twins do not provide significant assistance in the operation of the licensee's business or in the sale of products. They may institute quality-assurance controls, but ordinary trademark controls are not sufficient to satisfy this element.[11] Similarly, when Ford Motor Company produced Ford Explorer trucks using the Eddie Bauer name, Ford was using Eddie Bauer's trademark—and it paid a fee for the use of the mark. But since Eddie Bauer did not assist Ford in the manufacture of trucks, the promotion of those trucks or the operation of Ford's business, this was a true "license" arrangement that did not satisfy the "assistance or control" element of a franchise.

Minnesota (and others, such as New Jersey and Wisconsin) do not include "assistance or control" in the definition of a franchise. Rather, Minnesota's third element refers to a "community of interest" between the franchisor and franchisee. In *Martin v. Vanderbilt*, 269 N.W.2d 868 (Minn. 1978), the defendant received a percentage of the funds of each loan that was placed through its "consultants." The Minnesota Supreme Court determined a community of interest existed because the plaintiff and defendant each shared in fees "from a common source." Thus,

whenever a percentage royalty fee is charged, Minnesota's "community of interest" test will always be met.

The relationship will also satisfy the community of interest test in Minnesota when the dealer purchases products for resale from the seller. In *Unlimited Horizon Marketing, Inc. v. Precision Hub, Inc.*, 533 N.W.2d 63 (Minn. App. 1995), the distributor purchased machines for resale from a manufacturer. The court found that there was a community of interest between the parties because they would each profit from a common source upon the marketing and sale of the machine. This holding was extended in *Metro All Snax, Inc. v. All Snax, Inc.*, CCH ¶10,885 (D. Minn. 1996). In that case, there was no requirement for a payment based on a percentage of sales, and there were no purchases from the seller, but the defendant did receive a rebate from one of the dealer's suppliers. The court found that, as a result, both parties were profiting from the same source, namely the purchase and sale of these goods, and the community of interest test was met.

While several other states use the community of interest test as the third element of a franchise, courts in those states have rejected the concept that a community of interest exists whenever the two parties share in the revenues or profits from a common product or business. In *Cassidy Podell Lynch, Inc. v. Syndergeneral Corp.*, 944 F.2d 1131 (3d Cir. 1991), a federal appellate court, applying New Jersey law, said that for a community of interest to exist, a two-part test must be met: (1) the distributor must have made substantial "franchise-specific" investments, and (2) the distributor must have been required to make these investments by the parties' agreement or the nature of the business. To be a "franchise-specific" investment, the purchases must be such that they would have little or no value if not for the establishment of the relationship. The message of these cases is that if a dealer builds its business on the manufacturer's products, either because of the manufacturer's requirements or because of the nature of the relationship, the community of interest test will likely be satisfied.

Other courts that have interpreted the community of interest test have looked at the percentage of the dealer's business attributable to the relationship with the manufacturer. Thus, where only 38 percent of the dealer's business was attributable to the relationship with the manufacturer, no franchise was found to exist,[12] but where 76 percent of the dealer's revenue came from sales of the manufacturer's products, a community of interest existed.[13]

Some states, such as California, use the presence of a "marketing plan or system" as the third element of a franchise. It does not take much to meet this element. The provision of training or marketing materials that assist the dealer or licensee in marketing the product, or the conduct of extensive advertising campaigns, will satisfy this element.[14] California courts have also held that any oral or implied or suggested marketing plans or systems will satisfy this element.[15] Thus, even if you draft an agreement that does not provide this type of assistance, a court will take into account your client's oral promises, and its sales materials.

Surprises in Store

As indicated earlier, the label put on a relationship will have little bearing on whether or not the relationship constitutes a franchise. In *Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the United States of America, Inc.*, 549 F. 3d 1079 (7th Cir. 2008), an Eastern Wisconsin Girl Scout Council alleged that the Wisconsin Fair Dealership Law (the "WFDL") governed its relationship with Girl Scouts of America. While this law is slightly different from the franchise laws addressed above, the findings of the court are instructive. The local Girl Scout Council used the Girl Scout trademark. The Council also paid fees to Girl Scouts of America, based on the number of members in the Council. Thus, the issue turned on whether there was a "community of interest" in the relationship between the parties.[16] In determining that a community of interest existed, the court noted that the definition of a community of interest was one involving "a continuing financial interest between the grantor and grantee in either the operation of the dealership business or the marketing of ... goods or services."[17]

The court cited the Wisconsin Supreme Court's establishment of two "guideposts" to inform their analysis. Specifically, they looked at the "continuing financial interest" between the parties, espoused in *Cent. Corp. v. Research Prods. Corp.*, 681 N.W.2d 178, 187 (Wis. 2004), and to the level of "interdependence," or "the degree to which the dealer and grantor cooperate, coordinate their activities and share common goals in their business relationship," cited by *Ziegler Co. v. Rexnord, Inc.*, 407 N.W.2d 873, 878 (Wis. 1987). The court had no trouble finding interdependence between the two, since the Council devoted "100% of its time and resources to providing Girl Scouting to its jurisdiction." While this probably would have been sufficient to show the "interdependence," they also noted that the troop derived "virtually 100% of its profits from offering Girl Scout products and services," (specifically including $1 million a year from cookie sales) and therefore a continuing financial interest between the plaintiff and defendant existed. Thus, the court concluded that the community of interest test was met.

Ignoring Issue Costly

If the relationship is a franchise, then, unless there is an available exemption for a particular transaction, your client must register the franchise in more than a dozen states (including Minnesota), and it must, under federal law (and the laws of more than a dozen states), provide a fran-

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chise disclosure document to prospective franchisees at least 14 days before signing any agreement or accepting any payments. If a franchisor fails to comply with these laws, it is liable to the franchisee for damages or rescission, as well as attorney's fees. In addition, most of these laws have provisions for civil fines, and provide that the sale of an unregistered franchise is either a gross misdemeanor or a felony. Thus, it is critical that counsel for manufacturers, licensors and other potential franchisors recognize this issue *before* the establishment of the relationship.

Any relationship that falls within the definition of a franchise will also be subject to laws in a number of states, including Minnesota, that govern the relationship, including the manner in which the relationship can be terminated. Moreover, unfortunately, once your client terminates its relationship with a dealer, and the dealer is out of business, it may be impossible to undo the damage. In those cases, if the relationship is a franchise, your client may find itself liable for the entire value of the terminated franchisee's business, as well as the franchisee's attorney's fees.

If your client is liable for offering or terminating an agreement you prepared, without recognizing it was a franchise, then you and your law firm may be liable as well. A dozen years ago, a law firm in Connecticut found itself subject to a $15 million verdict, in favor of a former client, for allegedly failing to advise its client of the need to comply with the franchise registration and disclosure laws.[18] On appeal, the Connecticut Supreme Court affirmed that the law firm had committed malpractice, but set aside the damage recovery as being too speculative.[19] However, the case should send a clear warning to any attorney who prepares agreements that contain even two of the elements of a franchise that he needs to satisfy himself that the relationship is not a franchise under state or federal laws.[20]

Conclusion

Generally speaking, the franchise laws were written for traditional franchises like restaurants, hotels, and other business-format franchises. However, the franchise laws—as well as business opportunity laws and seller-marketing-plan laws (in Nebraska and California)—cover many relationships that we may not think of as franchises. These include manufacturer-dealer arrangements, licensing arrangements, and other relationships that meet the elements of a franchise regardless the creative name given to them. It is therefore critical that counsel understand the broad definition of a franchise (and business opportunity) under these laws to protect both herself and her client from incurring liability for failing to identify the "accidental franchise." ▲

Notes

[1] *See, e.g., Wright-Moore Corp. v. Ricoh Corp.*, 908 F.2d 128 (7th. Cir. 1990).

[2] Minn. Stat., §80C.01, subd. A4(a)(i).

[3] *See, e.g., Metro All Snax, Inc. v. All Snax, Inc.*, Bus. Franchise Guide (CCH) ¶10,885 (D. Minn. 1996).

[4] Under some state franchise laws, a business must be *substantially* associated with the trademark in order to satisfy the trademark element, in which case simply selling goods labeled with the putative franchisor's trademark may not be sufficient to meet this element of the test. *See, e.g., Gabana Gulf Distrib., Ltd. v. Gap Int'l Sales, Inc.*, Bus. Franchise Guide (CCH) ¶13,792 (N.D. Cal. 2008).

[5] Minn. Stat., §80C.01, subd. 9.

[6] Minn. Stat., §80C.01, subd. 9(f).

[7] *Id.* at 9(a).

[8] *See, e.g., Twin Cities Galleries, LLC v. Media Arts Group, Inc.*, 476 F.3d 598 (8th Cir. 2007).

[9] Minn. Stat., §80C.01, subd. 9.

[10] *See* Federal Trade Commission, Compliance Guide to the Amended FTC Rule, 3-4 (May 2008), *available at http://www.ftc.gov/bcp/edu/pubs/business/franchise/bus70.pdf* (providing that significant types of assistance include training programs and the furnishing of a detailed operations manual). *See also* FTC Informal Staff Advisory Opinion 95-5, Bus. Franchise Guide (CCH) 6500.

[11] *Id.* at 4.

[12] *New Jersey Am., Inc. v. Allied Corp.*, 875 F.2d 58, 63 (3d Cir. 1989).

[13] *Atlantic City Coin & Slot Serv. Co., Inc. v. IGT*, 14 F. Supp. 2d 644, 663 (D.N.J. 1998).

[14] *See, e.g., Boat & Motor Mart, Inc. v Sea Ray Boats, Inc.* (9th Cir. 1997) (the requirement of a dealer to conduct an extensive advertising campaign satisfied the marketing plan element); *U.S. Mac Corp. v. Amoco Oil Co.*, Bus Franchise Guide (CCH) 11,963 (Cal. App. Aug. 16, 2000) (finding that the provision of specialized training and the approval of advertising, along with grant of an exclusive territory and prohibition on sales of competing products, constituted a marketing plan).

[15] *People v. Kline*, 110 Cal. App. 3d 587 (Cal. App. 1980).

[16] The community of interest element is one of the elements of the WFDL, just as it is an element of the Minnesota Franchises Act. Wis. Stat. §135.02(1).

[17] *Id.*

[18] *Beverly Hills Concepts Inc. v. Schatz & Schatz, Ribicoff & Koitkin, et al.*, Bus. Franchise Guide (CCH) ¶11,099 (Conn. Super. Ct. 1997).

[19] 717 A.2d 724 (Conn. 1998).

[20] In a more recent case, a Nebraska attorney, and his law firm, were sanctioned for failing to provide competent representation in the field of franchise law. *See, State of Nebraska ex rel. Council for Discipline of the Nebraska Supreme Court v. Jeffrey L. Orr*, Bus. Franchise Guide (CCH) ¶14,064 (Neb. Sup. Ct. 2009).