Vinson Franchise Law Firm

BACKGROUND

This page explains the *basics* about U.S. franchise law. Franchise law is complex. There are *federal* laws governing franchising, and there are *state* laws governing franchising. These laws are not uniform, and they vary from state to state. To further complicate matters, there are state and federal laws that govern "business opportunities" and "seller-assisted marketing plans" that can also apply to franchising. This page explains *only* the basics. For a detailed understanding, you should consult with an experienced franchise lawyer.

OVERVIEW

Who regulates franchising?

Franchising is regulated by the U.S. Federal Trade Commission (FTC) and by various state agencies. The FTC Franchise Rule applies everywhere in the United States. A state's franchise laws usually apply only if:

- the offer or sale of a franchise is made in the state; or
- the franchised business will be located in the state; or
- the franchisee is a resident of the state.

What is a franchise?

Federal Law. Under the FTC Franchise Rule, there are 3 elements of a franchise:

1. Trademark. The franchisee is given the right to distribute goods and services that bear the franchisor's trademark, service mark, trade name, logo, or other commercial symbol.

2. Significant Control or Assistance. The franchisor has significant control of, or provides significance to the franchisee's method of operation. Examples of significant control or assistance include:

- approval of the site
- requirements for site design or appearance

- designated hours of operation
- specified production techniques
- required accounting practices
- required participation in promotional campaigns
- training programs
- providing an operations manual

3. Required Payment. The franchisee is required to pay the franchisor (or an affiliate of the franchisor) at least US$500 either before (or within 6 months after) opening for business. Required payments include any payments the franchisee makes to the franchisor for the right to be a franchisee. These include franchise fees, royalties, training fees, payments for services, and payments from the sale of products (unless reasonable amounts are sold at bona fide wholesale prices).

If all 3 elements are present, then the relationship will be a "franchise" for purposes of the FTC Franchise Rule.

State Law. State law definitions of franchises vary, but there are several common themes:

In 12 states, the 3 elements of the legal definition of a "franchise" are:

- *Marketing Plan.* The franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system substantially prescribed by the franchisor.
- *Association with Trademark.* The operation of the franchisee's business is substantially associated with the franchisor's trademark, trade name, service mark, etc.
- *Required Fee.* The franchisee is required to pay a fee, directly or indirectly.

These states are California, Illinois, Indiana, Iowa, Maryland, Michigan, North Dakota, Oregon, Rhode Island, Virginia, Washington, and Wisconsin.

In 5 other states, the 3 elements of the legal definition of a "franchise" are:

- *Trademark License.* The franchisee is granted the right to engage in the business of offering, selling or distributing goods or services using the franchisor's

trademark, trade name, service mark, etc.
- *Community of Interest*. The franchisor and franchisee have a community of interest in the marketing of goods or services.
- *Required Fee*. The franchisee is required to pay a fee, directly or indirectly.

These states are Hawaii, Minnesota, Mississippi, Nebraska, and South Dakota.

In Connecticut, Missouri, New York and New Jersey, the definition of a "franchise" involves some (but not all) of the elements in these 17 states. Finally, in Arkansas, Delaware and Florida, the state definitions are unique, and not like any other state.

What kind of franchise laws are there?

There are 3 general categories of laws regulating franchises: disclosure laws, registration laws, and relationship laws.

Disclosure laws regulate things like:

- required pre-sale disclosures;
- prohibited franchise sales practices; and
- mandatory cooling-off period before franchise sales.

Registration laws require things like:

- registration of the franchise;
- registration of franchise salespersons; and
- registration of franchise advertising.

Relationship laws govern certain aspects of the relationship between franchisor and franchisee, such as:

- grounds for terminating a franchise;
- notice and cure periods before termination;
- grounds for not renewing a franchise; and
- equal treatment of franchisees.

What are the most common types of violations of franchise laws?

- Offering or selling an unregistered franchise

- Failing to provide a UFOC on time
- Failing to provide all required disclosures in the UFOC
- Making misrepresentations to franchisee prospects
- Improperly terminating or not renewing a franchise

What are the penalties for violating franchise laws?

Governmental penalties for violating franchise laws can include fines, permanent bans on engaging in franchising, freezing of assets, money damages for victims, and even jail sentences. These penalties can be applied to the franchisor, and to its officers, directors, and managers who formulate, direct or control the franchisor's activities. The violation of state franchise laws is typically treated under the statutes as either a fraudulent and deceptive trade practice, or a misdemeanor, or a felony. In some states, a franchisee who has been harmed by the franchisor’s conduct can be awarded money damages (including punitive damages and attorneys fees), or cancellation of the franchise agreement and reimbursement of all fees paid to the franchisor.

DISCLOSURE LAWS

The FTC Franchise Rule requires franchisors to provide each prospective franchisee with a disclosure document, which is sometimes called an offering circular, at a certain point early in the process of offering and selling a franchise.

Laws in more than a dozen states also require franchisors to provide a similar disclosure document. Because the FTC format for disclosure does not satisfy the state-law requirements in these states, most franchisors choose to use the UFOC (Uniform Franchise Offering Circular) format which is acceptable in all of the registration states. The UFOC Guidelines are lengthy and detailed requirements for the preparation of a UFOC. See UFOC Outline for a discussion of these requirements.

The franchisor must give the UFOC to the prospect at the earlier of:

- the first face-to-face meeting with the prospect involving a discussion about the sale of a franchise; or

- at least 10 business days before the prospect signs any agreement with the franchisor; or
- at least 10 business days before the prospect pays any money to the franchisor.

The franchisor also must provide the prospect with a *complete* version of the franchise agreement (with all blanks filled in) at least 5 business days before the prospect signs any agreement or pays any money.

STATE REGISTRATION LAWS

Franchise Registration.

The FTC Franchise Rule does not provide for any registration of a franchise with the Federal Trade Commission, so there is no federal registration of franchises. However, various states require that franchises, business opportunities and seller-assisted marketing plans must be registered with the state before they can be sold in the state. The franchise registration states (and initial filing fees) are:

- California (US$675)
- Hawaii (US$250)
- Illinois (US$500)
- Indiana (US$500)
- Maryland (US$500)
- Michigan (US$250)
- Minnesota (US$400)
- New York (US$750)
- North Dakota (US$250)
- Rhode Island (US$500)
- South Dakota (US$250)
- Virginia (US$500)
- Washington (US$600)
- Wisconsin (US$400)

In most of these states, registration involves a review of the UFOC by a franchise regulator, who checks to make sure the UFOC meets the state requirements. But, in a few states, the UFOC is simply filed.

State registrations are generally valid for 1 year. In some states, the effective period of registration is a full calendar year from the first registration date; but, in other states, the registration expires a certain number of days (typically 90 to 120 days) after the end of the franchisor's fiscal year. To renew registration, a franchisor must file a renewal application or annual report each year, which includes certain forms, an updated UFOC, and a filing fee. Maryland also requires franchisors to file quarterly reports.

The UFOC also needs to be updated every time there is a change to any of the material information regarding the franchisor or the franchise opportunity. "Material information" means information that a potential franchisee could consider important in making a decision whether to invest in a franchise. If there are any of these changes, then the franchisor must update its UFOC and file an amendment in the relevant registration states.

Business Opportunity Registration or Exemption.

There are a number of states that require registration of business opportunities and seller-assisted market plans. The statutory definitions of these types of business relationships are often broad enough to include franchises, but most of these states provide some type of exemption for franchises that comply with the FTC Franchise Rule. The exemption is automatic in some states. But, to claim this exemption in Kentucky, Nebraska and Texas, there is a one-time filing required. To claim the exemption in Florida and Utah, it is necessary to file each year. The franchise exemption in Connecticut, Maine, North Carolina and South Carolina is available only for franchisors that have obtained registration of the trademarks or service marks involved in the franchise. Franchisors who do not have these mark registrations will need to register their franchise under the business opportunity laws if they will offer franchises in these states.

Advertising Filing.

Some states require that all advertising for the sale of franchises must be filed with the state before they are published. These states include: California, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota and Washington.

These states also generally have laws that restrict what franchisors can say in advertisements. These restrictions usually prohibit characterizing the franchise as a safe investment, or implying that state registration of the franchise means that the state has approved of the franchise. A few other states have similar content restrictions, but do not require the ads to be filed.

Salesperson Registration.

Most of the franchise registration states require the franchisor to file certain information about each person who will sell franchises in the state. This information includes the salesperson’s home address and phone number, business addresses and phone number, social security number, date of birth, five-year employment history, and information about certain civil and criminal proceedings involving the person. These states include California, Hawaii, Illinois, Indiana, Maryland, Minnesota, North Dakota, Rhode Island, South Dakota and Washington. If the salesperson is not an employee of the franchisor, Illinois, New York and Washington require that additional detailed information be filed.

STATE RELATIONSHIP LAWS

There is no federal law governing franchise relationships, although in the 1990s new legislation on this topic was proposed in Congress several times. There are 19 states that regulate some aspect of the franchise relationship. These states include Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, New Jersey, Michigan, Minnesota, Mississippi, Missouri, Nebraska, North Dakota, South Dakota, Virginia, Washington and Wisconsin.

Restrictions on Termination.

In all 19 states except for North Dakota, it is illegal for a franchisor to terminate a franchise agreement without good cause. "Good cause" usually includes things like:

- the franchisee become insolvent or bankrupt;
- the franchisee voluntarily abandons its operations;
- the franchisee is convicted of a crime relating to the franchise operations; or
- the franchisee fails to substantially comply with its material obligations under the franchise agreement.

These laws typically require the franchisor to give the franchisee written notice of the proposed termination a certain number of days before the termination. This advance notice period ranges from 30 to 120 days. These laws also usually provide the franchisee with an opportunity to cure the default, although there are often exceptions for defaults that cannot be cured such as voluntary abandonment, bankruptcy, and criminal conviction.

Restrictions on Non-Renewal.

State laws do not require franchise agreements to include a provision for renewal of the franchise after the end of the initial term. But, if a franchise agreement does have a renewal provision, then the franchise relationship laws in 12 states restrict the franchisor's ability to not renew the franchise. Most of these state treat non-renewal just like termination. This means that a franchisor must renew the franchise unless there is good cause no to, and the franchisee has been given the required advance written notice and opportunity to cure. These states include: Arkansas, Connecticut, Delaware, Hawaii, Iowa, Indiana, Minnesota, Mississippi, Missouri, Nebraska, New Jersey and Wisconsin.

The relevant laws in California, Illinois, Michigan and Washington require the franchisor to give the franchisee advance written notice of non-renewal (typically at least 6 months), and they impose certain restrictions or requirements on the franchisor in some circumstances, such as repurchase of the franchisee's assets, or waiver of any non-competition restrictions.

Repurchase Obligations.

In 10 states, the franchisor must repurchase some or all of the franchisee's furnishings, equipment, inventory, supplies and other assets following the end of the franchise relationship. These states include: Arkansas, California, Connecticut, Hawaii, Illinois, Iowa, Michigan, North Dakota, Washington and Wisconsin. Most of these states allow the franchisor to offset any money the franchisee owes to the franchisor. In Arkansas and California, the repurchase obligation is only imposed in certain situation where the termination or non-renewal by the franchisor violates state law. In Connecticut, the law requires the franchisor to repurchase certain of the franchisee’s assets following any termination of the franchise, and in Hawaii and

Washington, the repurchase obligation applies to terminations and non-renewals. The repurchase requirement is more limited in Illinois, Iowa, Michigan, North Dakota and Wisconsin.

Transfer Restrictions.

In 10 states, it is illegal for a franchisor to refuse to allow a transfer of the franchise without good cause. These states include: Arkansas, California, Hawaii, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey and Washington. Many of these states permit a franchisor to have a right of first refusal to purchase the franchise prior to a transfer. The California and Indiana statutes limit the circumstances in which transfer must be allowed. In California, the spouse, heirs and estate of a deceased franchisee/dealer can operate the business, if they qualify, or they can transfer the business to a qualified third party. Indiana simply grants the spouse, heirs and estate of a deceased franchisee/dealer the right to operate the business for a reasonable period of time.

Other Restrictions.

There are various other restrictions or requirements imposed on franchise relationships by state law. Some of these include:

- *Encroachment*. The franchisor's ability to open a new unit in the vicinity of a franchise's existing unit is regulated in Hawaii, Indiana, Iowa, Minnesota and Washington.
- *Free Association*. It is illegal for a franchisor to prohibit free association among franchisees or to prohibit them from participating in a trade association in Arkansas, California, Hawaii, Illinois, Iowa, Michigan, Minnesota, Nebraska, New Jersey, Rhode Island and Washington.
- *Good Faith / Reasonableness*. A franchisor must deal with its franchisees in a commercially reasonable manner and/or in good faith in Arkansas, Hawaii, Iowa, Minnesota, Nebraska, New Jersey and Washington.
- *Management*. It is illegal for a franchisor to require or prohibit any change in the management of the franchisee without good cause in Arkansas, Minnesota, Nebraska and New Jersey.
- *Marketing Fees*. It is illegal to collect marketing fees from franchisees and not

spend them on marketing in Arkansas.

- *Non-Compete Agreements*. The scope of a franchisee's non-competition agreement is limited in Indiana, and Louisiana.
- *Non-Discrimination*. It illegal for a franchisor to discriminate among similarly situated franchisees in Hawaii, Illinois, Indiana, Minnesota and Washington.
- *Non-Waiver*. A franchisee's waiver of any of the protections provided to it under state law is illegal or unenforceable in every state.
- *Required Purchases*. There are limits on a franchisor's ability to require franchisees to purchase supplies, inventory, goods and services from the franchisor or designated sources in Hawaii, Indiana, Iowa and Washington.