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The Dangers of Inclusion

Making distributorships compliant with state franchise and business opportunity laws

The immediate response that business owners and in-house counsel may give to the question of whether they are compliant with state franchise laws is "Why would we have to be in compliance when we are not a franchise?" or "the Federal Trade Commission's Franchise Rule does not apply to my business," ending the inquiry without a second glance toward state law applications. Nevertheless, a closer look at the state franchise and business opportunity statutes in comparison to a distributorship arrangement, including the intent behind such laws, may require counsel to venture a more cautious response.

There is a vast difference between the legal view and the commonplace view of what encompasses a distributorship compared to a franchise or business opportunity. When one considers the makeup of a prototypical franchise, one envisions a Blimpies, Gold's Gym or Dunkin Donuts storefront sprawled throughout suburbia and cities alike. However, many are unaware of the broad reach of state franchise and/or business opportunity laws, and the civil and criminal penalties that may result from failing to register or otherwise comply with such statutes.

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To "franchise," as defined by *Black's Law Dictionary*, Seventh Edition (1999), is "to grant (to another) the sole right of engaging in a certain business or in a business using a particular trademark in a certain area." Franchising has been a popular mode of business operations since the mid-20th Century. In reaction to major abuses to which personal investments were lost through numerous fraudulent schemes under the cloak of a "franchise" opportunity, California enacted the first set of laws governing the disclosure and registration of franchises in 1971, followed by several other states shortly thereafter.

The problem lies in the broad scope and application of state franchise and business opportunity laws, and the requirements that follow if such an arrangement applies pursuant to either statute. Some states, such as Connecticut, have franchise laws that govern only the franchise relationship, while others mandate strict filing and disclosure requirements upon the franchisor. Currently, 15 states maintain statutes governing the offer or sale of franchises, and 21 states regulate the offer and sale of business opportunities. While the requirements vary by state, the result is an increase in necessary filing fees, the disclosure of often otherwise private financial information and a long and burdensome process. Such disclosures make certain private information publicly available, an effect that is likely ill perceived by private businesses in competitive industries.

State franchise laws generally come in two flavors: marketing plan definition and community of interest definition. The "marketing plan" definition states have three requirements for coverage under the statute: (1) the franchisee's business is substantially associated with the franchisor's trademark; (2) the franchisee is granted the right to engage in the business at issue under a marketing plan subscribed to in substantial part by the franchisor; and (3) the payment of a franchise fee, whether direct or indirect. *See*, *e.g.*, Cal. Corp. Code § 31005. Although some states have departed from the generic definition, many follow the aforementioned pattern. The "community of interest" definition states also have three requirements that must be present to achieve coverage under the statute: (1) the franchisee uses the franchisor's trademark in any manner; (2) there is a community of financial interest between the franchisee and franchisor; and (3) the payment of a franchise fee, whether direct or indirect. *See*, *e.g.*, N.J.S.A. § 56:10-3a. The phrase "franchise fee" generally means any fee that a franchisee is required to pay directly or indirectly for the right to conduct a business to sell, resell or distribute goods, services or franchises under a contract agreement, including, but not limited to, any such payment for goods or services. Nevertheless, "franchise fee" usually does not include the purchase or agreement to purchase goods at a bona fide wholesale price under most state franchise statutes. Although few states have developed case law interpretations of the elements consti-

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tuting a franchise, many states also provide instruction through regulations and advisory opinions.

Business opportunity laws, by comparison, often require a more burdensome financial requirement in that a company offering such a business opportunity must maintain a surety bond before the sale of a business opportunity in addition to meeting disclosure and registration requirements. The purposes of business opportunity laws are to protect unsophisticated investors from fast-talking fly-by-night hustlers that could potentially leave the investor without any recourse or retribution against a fraudulent seller. Many states have business opportunity laws that closely parallel franchise laws, enabling some arrangements arguably to fall within both sets of requirements.

In most states, for an arrangement to qualify as a "business opportunity," there must be an offer, sale or lease of goods or services to a purchaser, usually to start a business, and there must be certain representations (which vary by state) made to the purchaser regarding the business. Examples of such business opportunities include sellers of amusement machines or vending machine routes, and most states follow standard representations, such as where the seller represents to the investor a guarantee of income, a full refund if unsatisfied, or provides the investor with a marketing plan or assistance in finding profitable locations. However, these examples are not an exhaustive list of possible business opportunities.

Some states, such as Virginia and Georgia, require only that certain disclosures be provided to the prospective purchaser without any state filing requirements. Nevertheless, both of those states still require financial statement disclosures, and both require the provider of the business opportunity to post a bond or escrow account in an amount as high as $75,000. Va. Code § 59.1-264; Va. Code § 59.1-265; Ga. Code Ann., § 10-411(b); Ga. Code Ann., § 10-412. Thus, even without public filing, these state requirements place a large burden on a company's competitive edge by providing the market with otherwise private financial information.

Many states provide exemption from the registration and disclosure provisions of franchise and business opportunity laws for certain businesses, such as gas stations or automobile dealers where there are substantive laws governing such relationships, and for purchasers or sellers of an opportunity with a net worth over a certain amount, often $1 million. *See*, *e.g.*, Va. Code § 19-28.1-6. The latter exemptions are based on the policy that buyers with a large net worth have the knowledge and experience with business matters to be properly safeguarded, and that buyers have recourse against sellers with a large net worth via the court system. It is unclear why more states do not provide exceptions for arrangements that are clearly governed by other applicable state law, such as in the petroleum (e.g. gas stations) and automobile (e.g. dealerships) industries.

For an example of a business relationship that could constitute a "franchise" or "business opportunity" under certain state laws, consider the following example of a promotional items manufacturer that distributes such items as pens, hats, tee-shirts, or Frisbees manufactured and printed by an independent salesman. The manufacturer offers to independent salesman a free Web site to display and sell the manufacturer's products. The Web site incorporates logos and/or trade names of both parties, and the manufacturer charges the salesman $20 per year to help maintain the Web site server and upkeep and $500 for business cards and brochures for distribution to prospective customers, a price deemed to be less than actual cost.

As a backdrop for this example, consider the franchise laws of New York and the business opportunity laws of Virginia. N.Y. Gen. Bus. Law § 681(3) defines franchise to consist of two elements: 1) a direct or indirect franchise fee; and 2) either a marketing plan prescribed in substantial part by a franchisor or a license or grant to the franchisee of the right to distribute goods or services substantially associated with the franchisor's trademark, service mark, trade name, logo or other commercial symbol. In application to the example, it seems that such an arrangement would be considered a franchise in New York because a fee is paid by the salesman and it seems that the salesman has both a marketing plan (the Web site) and a license or grant to distribute goods associated with the manufacturer's trademark.

The Virginia laws governing business opportunities are similar to those of other states, except that a sales program granted in conjunction with a federally registered trademark is not exempted from the law as in most states. Va. Code § 59.1-263(A) defines "business opportunity" as the sale of any products, equipment, supplies, or services sold to the purchaser for more than $500 to enable the purchaser to start a business if one of the representations noted above is present. In application to the instant case, because the element of an additional representation is satisfied when the seller provided a marketing program that could enable the investor to make a profit, and because the total cost of this arrangement is over the $500 threshold amount, this arrangement may constitute a business opportunity under Virginia law.

One can think of countless distribution arrangements, as well as other business ventures, that reside under the broad umbrella of such franchise and business opportunity laws that have probably not registered or provided such required disclosures: entities that distribute food and drinks to cart or truck vendors who rent the cart or truck from the entity; companies that lease town cars and taxi cabs to individuals for a fee with promises of income and publicity through marketing efforts such as a "1-800" phone number; automobile manufacturers or distributors that sell vehicles to dealerships along with sales brochures and other marketing assistance. The possibilities are endless.

Attorneys that counsel clients regarding distributorship or supply agreements must be careful to comply with certain substantive requirements of state franchise or business opportunity laws. Without such counsel, many businesses face the potentially unfavorable consequences of civil fines, criminal penalties and potential invalidity of otherwise valid distributorship agreements. The question remains: Is it worth risking a civil penalty for failing to register or disclose when the ultimate consequence of disclosure is the loss of a company's competitive edge? That question is left for corporate directors and counsel to decide. ■