

# Federal Franchise Regulation: A Definitional Dilemma

*The Federal Trade Commission recently enacted its first federal franchise regulation. This comment analyzes the scope of the new "franchise" definition contained in the regulation. An approach is offered to help determine whether contemplated business arrangements are encompassed in the FTC definition.*

## INTRODUCTION

In order to deal effectively with the abuses connected with franchising, the Federal Trade Commission (FTC) recently enacted its first federal franchise regulation.<sup>1</sup> This new FTC rule focuses on the "informational imbalance" which often exists between franchisors and prospective franchisees<sup>2</sup> and requires that the franchisees receive a detailed disclosure document concerning the franchise.<sup>3</sup> This disclosure requirement thus allows prospective franchisees the opportunity to assess risks and potential benefits before entering into an agreement.

The FTC rule does not regulate the substantive terms of a franchise agreement. Instead, it requires full and accurate disclosure of relevant information,<sup>4</sup> similar to the disclosure re-

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<sup>1</sup> Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. § 436.1-436.3 (1980).

<sup>2</sup> The "informational imbalance" results from franchisors' negotiating franchise agreements which are often long and complicated. Although the franchisor "knows how much information is fact and how much is mere puffery," franchisees are often unfamiliar with franchise contract negotiations. 43 Fed. Reg. 59614, 59625 (1978) (Comment by Professor Ozanne).

<sup>3</sup> The rule requires twenty specific disclosures to be contained in a single disclosure document. 16 C.F.R. § 436.1(a)(21)(1980). In general, the document must disclose: 1) the identity of the franchisor; 2) the business experience of the franchisor, directors and executives; 3) the litigation and bankruptcy history of the franchise; 4) the description of the franchise and all conditions of the relationship; 5) the termination provisions; and 6) the financial status of the franchise. 16 C.F.R. § 436.1(a)(1)-436.1(a)(20)(1980).

<sup>4</sup> See note 3 *supra*.

quired by the Securities and Exchange Commission.<sup>5</sup> Unlike a securities prospectus, however, the FTC does not register, file, or approve the FTC disclosure document.<sup>6</sup> This lack of central FTC review before the franchise begins can lead to conflicting interpretations of the disclosure requirements.

Although franchise regulation may be necessary and beneficial to inexperienced franchisees, regulation can be prohibitively burdensome to some franchisors. Small franchisors, in particular, will bear the brunt of most of the regulations.<sup>7</sup> For example, obtaining disclosure information and drafting a sound document are expenses small franchisors often cannot afford. In contrast, large established franchisors with unlimited funds and access to expensive legal advice will have little difficulty complying with the FTC rule. Thus, compliance will be more difficult and the penalties for violation<sup>8</sup> more burdensome for small businesses.

The FTC rule only applies if the business is a "franchise" within the regulation's definition. In order to aid small busi-

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<sup>5</sup> For an example of the information required in securities registration statements, see Schedule A, 15 U.S.C. § 77 aa (1976). For a discussion of the FTC rule in the context of securities regulation, see Comment, *Franchising: Probable Impact of the New Federal Trade Commission Rule*, 40 OHIO ST. L.J. 387 (1979).

<sup>6</sup> GUIDES TO COMPLIANCE WITH FTC FRANCHISING RULE, [1979] 396 TRADE REG. REP. (CCH) Pt. II, at 1 [hereinafter cited as FTC GUIDES].

<sup>7</sup> For a discussion of the burdens imposed on small franchisors by excessive disclosure requirements, see *The Role of Small Business in Franchising: Hearings Before the Subcommittee on Minority Small Business Enterprise and Franchising of the Permanent Select Committee on Small Business*, 93rd Cong., 1st Sess. 315 (1973) (statement on behalf of International Franchise Association before Federal Trade Commission Hearing on Proposed Trade Regulation Rule). See also H. BROWN, *FRANCHISING REALITIES AND REMEDIES* 178 (2d ed. 1978); 923 ANTITRUST & TRADE REG. REP. (BNA) A-12 (July 19, 1979).

<sup>8</sup> A violation occurs and it is an "unfair or deceptive practice" within the meaning of section 5 of the FTC Act, Federal Trade Commission Improvements, Pub. L. No. 93-637, § 1201, 88 Stat. 2193 (codified at 15 U.S.C. § 145 (1976)), specifically if the franchisor: 1) fails to provide prospective franchisees with the basic disclosure document; 2) makes representations about actual or potential sales or profits without adequate documentation; 3) makes any claim or representation without information required to be disclosed; 4) fails to provide within the established time frames, copies of the franchise agreement; or 5) fails to return refundable deposits. The FTC may assess civil penalties of up to \$10,000 per violation for those who fail to comply with the rule. The Commission may bring an action in Federal or state court for damages on behalf of the franchisee. The Commission also interprets the FTC rule as granting a private right of action to the injured party. FTC GUIDES, *supra* note 6, at 17-18.

nesses, this comment analyzes the FTC's "franchise" definition and attempts to determine what sort of business arrangements are subject to the rule's new disclosure requirements. Specifically, this comment will analyze the ambiguity of the FTC rule's package/product franchise definition.<sup>9</sup> An approach is offered to help determine whether contemplated business arrangements are encompassed in the package/product franchise definition. This comment also offers a list of precautions for those persons concerned with drafting an agreement outside the scope of the FTC definition.

### I. SCOPE OF THE FTC RULE

The FTC defines "franchise" to include what it terms, "package/product" franchises.<sup>10</sup> Package/product franchises share

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<sup>9</sup> An arrangement is a "package/product" franchise where:

[A] a person (hereinafter 'franchisee') offers, sells, or distributes to any person other than a 'franchisor' (as hereinafter defined), goods, commodities, or services which are:

(1) Identified by a trademark, service mark, trade name, advertising or other commercial symbol designating another person (hereinafter 'franchisor'); or

(2) Indirectly or directly required or advised to meet the quality standards prescribed by another person (hereinafter 'franchisor') where the franchisee operates under a name using the trademark, service mark, trade name, advertising or other commercial symbol designating the franchisor; and

(B)(1) The franchisor exerts or has authority to exert a significant degree of control over the franchisee's method of operation, including but not limited to, the franchisee's business organization, promotional activities, management, marketing plan or business affairs; or

(2) The franchisor gives significant assistance to the franchisee in the latter's method of operation, including, but not limited to, the franchisee's business organization, management, marketing plan, promotional activities, or business affairs; *Provided, however,* That [sic] assistance in the franchisee's promotional activities shall not, in the absence of assistance in other areas of the franchisee's method of operation, constitute significant assistance; . . . [and]

[C] The franchisee is required as a condition of obtaining or commencing the franchise operation to make a payment or commitment to pay to the franchisor, or to a person affiliated with the franchisor. 16 C.F.R. § 436.2 (1980).

<sup>10</sup> The FTC rule also applies to "business opportunity ventures." Since application of the "business opportunity venture" definition is relatively straightforward, it is not discussed in this comment. For discussions of this type of

three common elements: (1) the franchisee must either *distribute goods identified by or operate under a name using the franchisor's trademark* or commercial symbol; (2) the franchisor must either exert or have the authority to exert a *significant degree of control over or provide assistance* to the franchisee's method of operation; and (3) the franchisee must give the franchisor a *payment or commitment to pay* for the arrangement.<sup>11</sup>

While the trademark requirement<sup>12</sup> is already the subject of a

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FTC franchise, *see* FTC GUIDES, *supra* note 6, at 6; 43 Fed. Reg. 59614, 59698 & 59706 (1978).

The FTC rule exempts or excludes eight types of business arrangements from compliance with the FTC rule. Exempted arrangements *are* franchises, but need not comply with the rule. Excluded arrangements *are not* franchises, but are arrangements which might inadvertently be interpreted as falling within the definition. 43 Fed. Reg. 59614, 59706, 59708 (1978).

The rule provides *exemptions* for fractional franchises, leased departments, minimal investments and oral agreements. 16 C.F.R. §§ 436.2(a)(3)(i)-436.2(a)(3)(iv)(1980). "Fractional franchises" are arrangements where established distributors add a franchised product to an existing line. The agreement establishing the franchise relationship must represent less than 20% of the sales in dollar volume of the distributor. A "leased department" is typically a retailer who leases space inside a large department store. Lessees are usually business persons already experienced in the distribution of merchandise. A "minimal investment" franchise is one requiring a payment of less than \$500 for the association. The amount includes payments made any time before, and up to six months after, the commencement of the franchise operation. "Oral agreements" are usually informal, requiring only nominal investments. Where there is any writing, even if unsigned, with respect to material terms of the agreement, there will be no exemption. The purpose here is similar to that of the U.C.C. Statute of Frauds. For further discussion of exemptions, *see* FTC GUIDES, *supra* note 6, at 7-8.

The FTC definition *excludes* employer-employee and general partnership agreements, cooperative associations, certification or testing centers, and "single" trademark licenses. 16 C.F.R. §§ 436.2 (a)(4)(i) - 436.2 (a)(4)(iv)(1980). For a discussion of these exclusions, *see* FTC GUIDES, *supra* note 6, at 8 - 9.

<sup>11</sup> In addition to these three elements, there is an additional requirement that the arrangement be a "continuing commercial relationship." 16 C.F.R. § 436.2 (a)(1980). The parties must contemplate a course of dealings over a period of time coupled with the expectation of profit. 43 Fed. Reg. 59614, 59700 (1978).

<sup>12</sup> The FTC rule is not intended to cover a business arrangement where no mark is involved. Thus, according to the FTC, "the supplier may avoid coverage under the rule by expressly prohibiting the use of its mark by the distributor." FTC GUIDES, *supra* note 6, at 3.

vast area of federal law,<sup>13</sup> the latter two requirements have previously only appeared in state statutes.<sup>14</sup> To aid in the construction of these concepts, the FTC has stated that state law is relevant in interpreting these requirements.<sup>15</sup> This transfer of state law concepts into substantive federal law, even absent any textual ambiguities, can potentially lead to conflicting interpretations.<sup>16</sup> The FTC rule, however, has compounded the problem by promulgating substantive rules that are ambiguous. Both the "significant control over or assistance to the franchisee's method of operation" and "payment or commitment to pay" requirements are vague; however an analysis of each can alleviate some of this ambiguity.

### A. Significant Control or Assistance

The requirement of "significant control over or assistance to the franchisee's method of operation" raises two issues: first, what factors in an agreement will constitute control or assistance, and second, to what degree must control or assistance be present in order to be characterized as "significant." The FTC

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<sup>13</sup> See generally Lanham Act, 15 U.S.C. § 1051 *et seq.* (1976); J. McCARTHY, TRADEMARK AND UNFAIR COMPETITION (1973).

<sup>14</sup> State franchise definitions have basically come in two forms. The California type, in addition to a trademark requirement, requires that: 1) the franchisee distribute goods or services "under a marketing plan or system prescribed in substantial part" by a franchisor; and 2) the franchisee "pay, directly or indirectly, a franchise fee." CAL. CORP. CODE § 31005 (West 1977). In contrast, the Washington type, in addition to a trademark requirement, requires that 1) the franchisee and franchisor have a "community of interest" in the business; and 2) the franchisee "pay, directly or indirectly, a franchise fee." WASH. REV. CODE ANN. § 19.100.010 (4) (1978). For further discussion of these franchise definitions, see text accompanying notes 25-30 *infra*.

<sup>15</sup> In the FTC's explanation of significant control or assistance in method of operation, it suggests looking to the California and Illinois "marketing plan" franchise requirement for help in clarifying its requirement. 43 Fed. Reg. 59614, 59702 n. 41 (1978).

<sup>16</sup> See, e.g., Commissioner of Internal Revenue v. Stern, Transferee, 357 U.S. 39 (1958) (holding state law applicable to interpreting specific provision of the Internal Revenue Code of 1939); DeSilva v. Ballentine, Guardian, 351 U.S. 570 (1956) (holding state law applicable to interpreting the word "children" under the Copyright Act); Reconstruction Finance Corporation v. Beaver County, 328 U.S. 204 (1946) (holding state law applicable to interpreting the term "real property" in the Reconstruction Finance Corporation Act). *But see* Clearfield Trust Co. v. United States, 318 U.S. 363 (1943) (holding state law not applicable to interpreting Federal Law, where desirability of uniform rules is clear).

provides factors in its package/product franchise definition and guidelines<sup>17</sup> to aid in determining what constitutes control or assistance. The franchise definition<sup>18</sup> includes a list of five general areas in which control or assistance may arise: business organization, promotional activities, management, marketing plan and business affairs. Although control or assistance is not limited to these five areas, these areas are so broad that most franchisor actions are covered. Moreover, the FTC guidelines contain numerous examples of specific factors that can be used to determine whether control or assistance is present.<sup>19</sup> The FTC also lists factors which should not be considered.<sup>20</sup> These guidelines make it relatively simple to determine what factors will constitute controls or assistance.

It is more difficult to determine whether or not control or assistance is "significant." A threshold determination is whether or not the controls or assistance are related to the franchisee's "entire method of operation."<sup>21</sup> The FTC states that "controls or assistance directed to the sale of a specific product which have, at most, a marginal effect on the franchisee's method of operating their entire business will not be considered in determining

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<sup>17</sup> See FTC GUIDES, *supra* note 6, at 3-5; Proposed Guides to the Franchising and Business Opportunity Venture Trade Regulation Rule, 43 Fed. Reg. 59733, 59734, 59735 (1978); and Promulgation of Trade Regulation Rule and Statement of Basis and Purpose, 43 Fed. Reg. 59614, 59701-59703 (1978).

<sup>18</sup> See note 9 *supra*.

<sup>19</sup> Among significant types of control are those involving: 1) site approval for unestablished businesses; 2) site design or appearance requirements; 3) hours of operation; 4) production techniques; 5) accounting practices; 6) personnel policies and practices; 7) promotional campaigns; 8) restrictions on customers; and, 9) location or sales area restrictions.

Among significant types of assistance are: 1) providing formal sales, repair or business training programs; 2) establishing accounting systems; 3) furnishing management, marketing and personnel advice; 4) selecting site location; and 5) furnishing detailed operating manuals.

Items accorded less weight in the significant control determination are: 1) requirements that the franchisee service or repair products; 2) inventory controls; 3) required display of goods; and 4) on the job assistance in sales or repairs. FTC GUIDES, *supra* note 6, at 3-4.

<sup>20</sup> Items not considered in the significant control determination are: 1) controls designed to protect the trademark; 2) health or safety restrictions; 3) agreements to provide savings stamps; 4) agreements to provide credit card services; and 5) agreements to assist the franchisee in obtaining financing. FTC GUIDES, *supra* note 6, at 4.

<sup>21</sup> FTC GUIDES, *supra* note 6, at 5.

whether control or assistance is 'significant'.<sup>22</sup>

An examination of the underlying rationale of the FTC rule provides the key in a determination of "significant" control or assistance. The FTC believes that by significantly controlling or assisting franchisees in their method of operation, franchisors use their expertise to help franchisees avoid costly mistakes.<sup>23</sup> The result of this control or assistance is a corresponding loss of independence for franchisees. The FTC recognizes this, stating that the existence of "significant" control or assistance, "will turn primarily on the degree to which the distributor is dependent upon the franchisor's reputation and control or assistance."<sup>24</sup> The franchisee's loss of independence with respect to their method of operation is thus a decisive indicator as to whether or not there exists a "significant" degree of control or assistance.

Since the "significant" control or assistance determination is a factual one, it must be made on a case-by-case basis. The FTC has attempted to provide some guidance, by looking to similar state franchise laws.<sup>25</sup> Thus, certain state franchise definitions are relevant to interpreting this federal definition.

Most state franchise definitions can be categorized within two broad approaches: the "uniform business plan" approach and the "community of interest" approach.<sup>26</sup> The "uniform business

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<sup>22</sup> *Id.* The FTC determination not to regulate arrangements where franchisees are not involved with franchisors in their entire method of operation is also reflected in the "fractional franchise" exemption to the rule; see note 10 *supra*.

<sup>23</sup> See 43 Fed. Reg. 59614, 59699 (1978).

<sup>24</sup> 43 Fed. Reg. 59614, 59735 (1978).

<sup>25</sup> See note 15 *supra*.

<sup>26</sup> Fern, *The Overbroad Scope of Franchise Regulation: A Definitional Dilemma*, 34 BUS. LAW. 1387 (1979).

States which utilize the "uniform business plan" approach in their franchise definitions are: California (CAL. CORP. CODE § 31005 (West 1977)); Connecticut (CONN. GEN. STAT. ANN. § 42-133K (West Cum. Supp. 1980)); Illinois (ILL. ANN. STAT. ch. 121 ½, § 703 (Smith Hurd Supp. 1979)); Indiana (IND. CODE § 23-2-2.5-1 (1976)); Maryland (MD. CODE ANN. Art. 56, § 345 (1979)); Michigan (MICH. STAT. ANN. § 19.854(2) (1975)); North Dakota (N.D. CENT. CODE § 51-19-02 (Supp. 1979)); Oregon (OR. REV. STAT. § 650.005 (1977)); Rhode Island (R.I. GEN. LAWS § 19-28-3 (Supp. 1978)); Virginia (VA. CODE § 13.1-557 (1978)); and Wisconsin (WIS. STAT. ANN. § 553.03 (West Cum. Supp. 1979)).

States utilizing the "community of interest" approach in their franchise definitions are: Hawaii (HAWAII REV. STAT. § 482 E-2 (Supp. 1975)); Massachusetts (MASS. GEN. LAWS ANN. Ch. 93B, § 1(i) (West Cum. Supp. 1979)); Minnesota (MINN. STAT. ANN. § 80C.01 (West Cum. Supp. 1979)); Mississippi (MISS. CODE

plan" approach focuses on the existence of franchisors' advice and control tending to produce uniform business establishments.<sup>27</sup> In contrast, the "community of interest" approach focuses on whether the franchisor and franchisee "have a common interest in the activities of the other and profit from those activities."<sup>28</sup> Franchise definitions similar to California's, which require a "marketing plan or system prescribed in substantial part" by the franchisor, fall within the "uniform business plan" approach.<sup>29</sup> The FTC "package/product" franchise definition which requires "significant control or assistance" also falls

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ANN. § 75-24-5 (Supp. 1979)); Missouri (MO. ANN. STAT. § 407-400 (Vernon 1979)); New Jersey (N.J. STAT. ANN. § 56:10-3 (West Cum. Supp. 1979)); New Mexico (N.M. STAT. ANN. § 57-16-3 (1978)); South Dakota (S.D. COMPILED LAWS ANN. § 37-5A-1 (1977)); and Washington (WASH. REV. CODE ANN. § 19.100.010 (1978)).

<sup>27</sup> "The 'uniform business plan' approach defines a franchise in terms of the substantial and detailed advice given or control exercised, directly or indirectly, by the franchisor with respect to the manner in which the franchisee operates his business or markets his goods and services." Fern, *supra* note 26, at 1389.

For court decisions illustrating the "uniform business plan" approach see *Susser v. Carvel Corporation*, 206 F. Supp. 636 (S.D.N.Y. 1962), *aff'd*, 332 F.2d 505 (2d Cir. 1964) (although the case arose before the creation of state franchise regulations, the court clearly applied the "uniform business plan" approach in defining a franchise, where the franchisor exercised extensive controls over franchisees); *H & R Block Inc. v. Lovelace*, 208 Kan. 538, 493 P.2d 205 (1972) (franchise agreement giving franchisor control over franchisee's office hours, fees, methods and accounting procedures and training of personnel held to be "uniform business plan" franchise); *Weight Watchers of Rocky Mountain v. Weight Watchers Internatl.*, 1976-2 Trade Cas. ¶ 61,157 (W.D. Pa. 1973) (franchise agreement giving franchisor control over franchisee's conduct of classes, advertising, promotional materials and methods held to be "uniform business plan" franchise); *Weight Watchers of Quebec Ltd. v. Weight W. Int., Inc.*, 398 F. Supp. 1047, 1052 (E.D.N.Y. 1975) (court viewed a franchise as "a license coupled with restrictions to enforce either uniformity of operation or a minimum standard of service."). *But cf.* *Artman v. International Harvester Co.*, 1973-1 Trade Cas. ¶ 74,522 (E.D.N.Y. 1976) (court held purchase order document specifying quality and quantity of goods being sold as well as price paid did not reserve to the manufacturer any degree of control over the retailers' merchandising practices; thus the arrangement was not a franchise).

<sup>28</sup> Fern, *supra* note 26, at 1394. The "community of interest" plan approach defines a franchise "in terms of the mutual interest in the marketing of goods and services between the licensor and licensee." *Id.* at 1393.

<sup>29</sup> For a list of other states falling under the "uniform business plan" approach by requiring a "marketing plan or system prescribed in substantial part" by the franchisor, see note 26 *supra*.



within the "uniform business plan" approach.<sup>30</sup>

California's "franchise" requirement of a "marketing plan prescribed in substantial part" can provide guidance in interpreting the FTC requirement of "significant control or assistance."<sup>31</sup> In *Spahn v. Guild Industries Corp.*,<sup>32</sup> the California Court of Appeals held that an arrangement in which a franchisor provided franchisees with standard operating procedures, promotional materials, training and a marketing scheme contained a "marketing plan prescribed in substantial part" by the franchisor. The court first focused on the various items of control or assistance present in the arrangement, then concluded that the franchisor had control over the franchisee's entire business. In contrast, the California Corporations Commissioner had earlier found an arrangement where manufacturers only supplied dealers with products and provided facilities for training did not contain the requisite "marketing plan."<sup>33</sup> After examining the provisions of the arrangement, the Commissioner determined that dealers were free to promote and sell products in a manner of their own choosing.

The FTC package/product franchise definition may not, however, encompass all arrangements held to be franchises under the competing "community of interest" approach. Washington's franchise definition, for example, defines a "community of interest" as a "continuing financial interest" between the franchisor and franchisee.<sup>34</sup> Although other states utilizing the "community

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<sup>30</sup> See note 15 *supra*.

<sup>31</sup> *Id.* See text accompanying notes 28-30 *supra*. In the FTC's explanation of significant control or assistance in method of operation, it suggests looking to the California and Illinois "marketing plan" franchise requirement for help in clarifying its requirement. 43 Fed. Reg. 59614, 59702 n. 41 (1978).

<sup>32</sup> 94 Cal. App. 3d 143, 156 Cal. Rptr. 375 (1st Dist. 1979) (suit brought by franchised baby furniture distributor against franchisor for noncompliance with California Franchise Investment Law).

<sup>33</sup> Cal. Corp. Comm'r Op. No. 75/5F (1975), reprinted in CALIFORNIA COMMISSIONER OF CORPORATIONS, CURRENT OFFICIAL OPINIONS (Cal. Cont. Educ. Bar Supp. 1975). In this case manufacturers of a binding material for concrete supplied dealers with the product and facilities for training on the use of the product. Dealers were usually large established contractors whose sales of the manufacturer's product was only a small part of their total business.

<sup>34</sup> WASH. REV. CODE ANN. § 19.100.010 (1978). See also Hawaii's franchise definition which defines a "community of interest" as "a continuing financial interest between the franchisor and franchisee in the operation of the franchise business." HAW. REV. STAT. § 482 E-2 (Supp. 1975).

of interest" approach<sup>35</sup> have not defined the term as specifically as Washington, the Minnesota Supreme Court found in *Martin Investors, Inc. v. Vander Bie*<sup>36</sup> a "community of interest" where the franchisor had a right to 1% of the franchisee's proceeds. Since the franchisor and franchisees may have a "community of interest" in profits, without the franchisor exercising significant control over or assistance to franchisees, the FTC package/product franchise definition may not encompass franchises under all interpretations of the "community of interest" approach.

*Susser v. Carvel Corporation*,<sup>37</sup> a case illustrating the "uniform business plan" approach, demonstrates the scope of the FTC rule. In *Susser*, franchised ice cream store operators brought suit against the franchisor for antitrust violations. The franchise operators were subjected to a number of restrictions which tended to create a uniform system of operation. Carvel required all stores to be constructed according to approved plans. The required ice cream machines were designed by Carvel and bore its trademark. Franchisees were required to operate their stores according to a "Standard Operating Procedure Manual." The manual described the products which franchisees could sell, permissible advertising, store colors, hours the store lights must be on, required insurance amounts, employee's uniform color, and other details. Carvel received a royalty of 25 cents per gallon of ice cream mix used. The *Susser* court focused first on the trademark and then on "uniformity of product and control of quality and distribution" in finding the existence of a franchise.<sup>38</sup>

The FTC package/product franchise definition encompasses the Carvel franchise. The requirement of trademark use is present and a fee payment is present in the form of royalties.<sup>39</sup> The

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<sup>35</sup> For a list of states utilizing the "community of interest" approach, see note 26 *supra*.

<sup>36</sup> — Minn. —, 269 N.W.2d 868, 875 (1978). This case involved franchisees selling a computer service, matching needs of potential borrowers with potential lenders. The court found the requisite "community of interest" present where the franchisor and franchisees would share the fees obtained from borrowers.

<sup>37</sup> 206 F. Supp. 636 (S.D.N.Y. 1962), *aff'd*, 332 F.2d 505 (2d Cir. 1964). For a synopsis of the case see note 27 *supra*.

<sup>38</sup> *Id.* at 640.

<sup>39</sup> Royalties are considered fee payments. See text accompanying note 66 *infra*.

issue is whether Carvel exercises "significant control over or assistance" to its franchisees' methods of operation. By referring back to the lists of factors provided by the FTC,<sup>40</sup> Carvel's restrictions on site design or appearance, hours of operation, personnel policies and advertising are all items considered as "control." Although a restriction on products sold is not listed by the FTC as a control, it is similar in nature to those listed and thus, should be considered.<sup>41</sup> Requiring franchisees to maintain insurance is not as restrictive as those controls listed by the FTC and does not restrict the operation of business and, consequently, should have less of an impact. Carvel did not furnish any of the types of items listed by the FTC as "assistance" to its franchisees.<sup>42</sup>

Since items of control were present, the FTC rule requires an inquiry into whether the items are "significant." Carvel's franchisees were restricted in areas ranging from the design of their stores to the color of employee uniforms. They were restricted as to what they could sell and the type of machine they must use. Carvel's franchisees clearly lost independence with respect to their method of business operation; therefore, these controls would probably be held to be "significant."<sup>43</sup>

In *Shell Oil Co. v. Marinello*,<sup>44</sup> the New Jersey court utilized the competing "community of interest" approach in finding a franchise in a gasoline station lease and dealer arrangement. Shell leased service stations to its franchisees and agreed to supply them with products for resale. Shell's control over dealer sites and supply of products was sufficient for the court to find a franchise, even though "the amount of fuel, lubricant and TBA"<sup>45</sup> a station will sell is directly related to courtesy, service, cleanliness and hours of operation, all dependent on the particular

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<sup>40</sup> See notes 19 & 20 *supra*.

<sup>41</sup> For a list of FTC items of control, see note 19 *supra*. The FTC in its *proposed* guides, however, listed a restriction on sales of competitive products as a "significant control." 43 Fed. Reg. 59733, 59734 (1978).

<sup>42</sup> See note 19 *supra*.

<sup>43</sup> See text accompanying notes 23 & 24 *supra*.

<sup>44</sup> *Shell Oil Company v. Marinello*, 63 N.J. 402, 307 A.2d 598 (1973), *cert. denied*, 415 U.S. 920 (1974). For New Jersey's "franchise" definition, see note 26 *supra*.

<sup>45</sup> In the general oil sales industry, "TBA" means tires, batteries, and accessories.

operator."<sup>46</sup>

The FTC package/product franchise definition might not encompass the Shell franchise. While a trademark was present and the lease constituted a fee payment,<sup>47</sup> the issue would be whether the control over business site and supply of products constituted "significant" control. Although Shell franchisees were restricted in their business site and supply of products, they may not have lost their independence with respect to their method of business operation. Unlike Carvel's franchisees, Shell's franchisees were free to promote and sell products in a manner of their own choosing, therefore, significant control may not have been present.<sup>48</sup> Thus while the FTC approach parallels the "uniform business plan" approach, as an analysis of *Susser* demonstrates, it may be narrower than the "community of interest" approach utilized in *Shell*. Cases under the "uniform business plan" approach may consequently be more relevant to analysis of the new FTC rule's coverage, although any analysis must begin with the caveat that each case must be analyzed on its own facts.<sup>49</sup>

The requirement of "significant control or assistance," in addition to being difficult to analyze, can be criticized as overly broad.<sup>50</sup> The breadth of the requirement is apparent when one attempts to apply it to business arrangements not traditionally thought of as franchises. Trademark licenses<sup>51</sup> and ordinary distributorships,<sup>52</sup> for example, often involve a trademark and a fee

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<sup>46</sup> *Shell Oil Company v. Marinello*, 63 N.J. 402, 307 A.2d 598, 601 (1973).

<sup>47</sup> Payments for rent are considered fee payments. See text accompanying note 66 *infra*.

<sup>48</sup> For such a holding in a similar case, see note 33 *supra* and accompanying text.

<sup>49</sup> See text accompanying notes 17-25 *supra*.

<sup>50</sup> For examples of this criticism, see, e.g., Fern, *supra* note 26; 923 ANTI-TRUST & TRADE REG. REP. (BNA) A-12 (July 19, 1979); Kaul, *Trademark Licensing and the FTC Franchise Disclosure Rule*, 69 TRADEMARK REP. 142 (1979).

<sup>51</sup> Generally, a license is a permit from the owner of a patent, trademark, or tradename allowing another to use, sell, or manufacture a product for a limited period. G. GLICKMAN, FRANCHISING § 2.03 (2)(1979).

<sup>52</sup> Under ordinary distributorship agreements, distributors purchase goods from manufacturers and resell them to customers of their own choosing through independently operated businesses. Fromson, *The Distribution Agreement*, 47 N.Y. St. B.J. 23, 24 (1975).

payment in the arrangement.<sup>53</sup> Thus, they meet the initial requirements for a package/product franchise. The difficulty, however, lies in determining whether provisions of the arrangements constitute "significant control or assistance."<sup>54</sup>

Consider, for example, whether the FTC package/product franchise definition encompasses the following California distributorship agreement.<sup>55</sup> The manufacturer of a liquid substance used to remove wallpaper granted distributors the right to distribute the product, using the manufacturer's tradename.

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<sup>53</sup> "[I]n almost every trademark licensing situation, the licensee is interested in using the licensed trademark for the distribution of goods or services and is required to make some type of payment to the licensor for use of the trademark." Kaul, *Trademark Licensing and the FTC Franchise Disclosure Rule*, 69 TRADEMARK REP. 142, 148 (1979).

In many distributorship agreements manufacturers require distributors to sell products bearing their trademarks and require specified quantities of purchases upon commencing the franchise. See Black, *New Federal Trade Commission Franchise Disclosure Rule: Application to Distributorship Arrangements*, 35 BUS. LAW. 409, 417 (1980).

<sup>54</sup> According to the parties' needs, license agreements may contain specific provisions requiring the licensee to advertise, maintain records and accounts for verification of any royalties due to the licensor, limit sales to specific territories, use specified production techniques and permit inspection to protect the quality and reputation of the trademark. See, Mattes, *The Franchise Concept*, 47 CAL. ST. B. J. 300, 304-05 (1972) (discussion regarding applicability of California franchise definition to license agreements).

Some distributorships include provisions concerning the purchase of minimum inventories, patent infringement protections, exclusive sales territories, restrictions on selling competitive products, and promotional and service responsibilities on the part of the distributor including the use of best efforts. See, e.g., J. RABKIN & M. JOHNSON, CURRENT LEGAL FORMS FORMS 4.59, 4.60 (1979).

In the case of trademark licenses, significant control may always be present since, under the Lanham Act trademark licensors are required to exercise control over the licensee's use of the trademark. See 15 U.S.C. § 1127 (1977). See, e.g., *Robinson Co. v. Plastics Research & Development Corp.*, 264 F. Supp. 852 (W.D. Ark. 1967) (held that licensors abandon mark where they do not retain control over its use); *Dawn Donut Co. v. Hart's Food Stores, Inc.*, 267 F.2d 358 (2d Cir. 1959) (held that license is not abandoned where owner exercises reasonable control over its use). See also Kaul, *Trademark Licensing and the FTC Franchise Disclosure Rule*, 69 TRADEMARK REP. 142 (1979).

<sup>55</sup> Cal. Corp. Comm'r Op. No. 73/30F (1975), reprinted in CALIFORNIA COMMISSIONER OF CORPORATIONS, CURRENT OFFICIAL OPINIONS (Cal. Cont. Educ. Bar Supp. 1973) (distributorship agreement containing the factors listed constituted a "marketing plan or system prescribed in substantial part" by a franchisor, thus fell within the California franchise definition).

The manufacturer restricted distributors in their distribution territories, competitive product sales and sales prices. The manufacturer also required distributors to maintain adequate inventories and use best efforts. The requirement of a trademark was present and the requirement of a fee payment was also present in the form of required purchases.<sup>56</sup>

An application of the "loss of independence" analysis<sup>57</sup> aids the classification of this distributorship as a franchise under the FTC rule. The first step under this analysis is to determine whether items of control or assistance are present. The FTC factor lists<sup>58</sup> provide aid in this determination. According to these lists, items of control comprise inventory controls and a requirement to use best efforts; although these are to be considered to a "lesser extent." The imposition of exclusive sales territories is another item considered to be control.<sup>59</sup> Restrictions on the sale of competitive products and sales prices are not listed as items for consideration.<sup>60</sup> However, because they are similar in nature to those items listed, and impair the franchisee in the operation of business, they should be considered.<sup>61</sup>

When the above provisions are present, control is present. This in turn leads to the next step in the analysis where the franchisee's loss of independence is assessed. Under the distributorship agreement, distributors are restricted in what they can sell and where they can operate. The manufacturer sets prices and requires that certain levels of inventories be kept. These factors strongly indicate that distributors have lost independence. The element of "significant control or assistance" is thus present.

The distributorship and license arrangements illustrate the breadth of the "significant control or assistance" requirement. The requirement must necessarily be somewhat vague, in order to encompass all relationships where "franchisees" suffer the loss of independence described in the underlying rationale of the rule.<sup>62</sup> By providing guidance as to which combinations of items

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<sup>56</sup> See text accompanying notes 66 & 67 *infra*.

<sup>57</sup> See text accompanying notes 17-25 *supra*.

<sup>58</sup> Set forth in notes 19 & 20 *supra*.

<sup>59</sup> *Id.*

<sup>60</sup> See notes 19 & 20 *supra*.

<sup>61</sup> See note 41 *supra*.

<sup>62</sup> See text accompanying notes 23 & 24 *supra*.

in an arrangement would constitute "significant" control or assistance, however, the FTC could provide some added clarity to an otherwise vague requirement.

### B. Payment or Commitment to Pay

The requirement in the FTC definition that the franchisee make a "payment or a commitment to pay to the franchisor" is also subject to some uncertainty. The FTC has decided that franchises with fees less than \$500 are excluded from the rule.<sup>63</sup> The franchise fee is intended to include all revenue the franchisee must pay to the franchisor or an affiliate for the right of association.<sup>64</sup> The fee includes payments made at any time before the franchisee commences business up to six months after that date.<sup>65</sup> Initial franchise fees, rent, royalties on sales, payments for advertising and for equipment and supplies are examples of payments within the definition.<sup>66</sup> Payments for start-up inventories will not be included as fee payments as long as they are purchases of reasonable amounts at bona fide wholesale prices.<sup>67</sup>

The first problem with the fee requirement is that the FTC includes royalties on sales as fee payments<sup>68</sup> but does not specify whether the \$500 minimum includes anticipated royalties. At the outset of a business arrangement, franchisors are only capable of making estimates of royalties, thus it would be inequitable to penalize them should their good faith estimates turn out to be too low. The purpose of setting a minimum of \$500 is to "focus

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<sup>63</sup> Arrangements are exempted where the total of payments made from any time prior to, within up to 6 months after commencing operation of the franchisee's business, are less than \$500. 16 C.F.R. § 436.2(3)(ii) (1980). See also note 10 *supra*. Where franchisees make no significant investment, they assume a limited risk and the protection of the rule is unnecessary. Typical of business relationships where there is no significant financial investments are those between "producers and commissioned salespersons, agents and other direct sellers." 43 Fed. Reg. 59614, 59704 (1978).

<sup>64</sup> FTC GUIDES, *supra* note 6, at 5.

<sup>65</sup> See note 63 *supra*.

<sup>66</sup> Also listed as payments are payments for training, security deposits, escrow deposits, non-refundable bookkeeping charges, promotional literature, payments for services of persons to be established in business and equipment rental. FTC GUIDES, *supra* note 6, at 5.

<sup>67</sup> FTC GUIDES, *supra* note 6 at 6.

<sup>68</sup> See note 66 and accompanying text *supra*.

upon those franchisees who have made a personally significant monetary investment and who cannot extricate themselves from the unsatisfactory relationship without suffering financial setback."<sup>69</sup> Since royalty payments need not be paid until the franchisee profits, it is difficult to understand why they are included in the fee payment determination.

The second and most troublesome aspect of the fee requirement is that it only encompasses payments made to the franchisor or an affiliate. Required purchases from third parties unaffiliated with the franchisor are not included as fee payments.<sup>70</sup> Franchise agreements requiring franchisees to make substantial investments for opening their businesses may also be excluded. Given the payment requirement's purpose to protect franchisees with substantial investments into the business, these investments to third parties should be afforded the same degree of disclosure as payments to the franchisor.

A few franchisors will undoubtedly frustrate the intent of the \$500 rule by placing a \$499 fee on association with their franchise. Such schemes can never be avoided when dealing with specific monetary requirements. However, in placing a minimum fee in the definition, the FTC has provided at least some certainty in an otherwise nebulous definition.

## II. PRECAUTIONS FOR BORDERLINE FRANCHISORS

Borderline franchisors concerned with drafting agreements not encompassed within the FTC franchise definition should take several precautions. First, the borderline franchisor should not characterize the agreement as an FTC franchise or refer to

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<sup>69</sup> 43 Fed. Reg. 59614, 59704 (1978).

<sup>70</sup> 43 Fed. Reg. 59614, 59703 (1978).

A related problem with the fee requirement is that it is unclear whether \$500 worth of advertising or promotional benefit to the franchisor would constitute a fee payment. Consider, for example an agreement requiring the franchisee to run weekly television advertisements. Under California's fee payment requirement, these sort of indirect payments may constitute franchise fees. See Cal. Corp. Comm'r Op. No. 74/3F (1974), reprinted in CALIFORNIA COMMISSIONER OF CORPORATIONS, CURRENT OFFICIAL OPINIONS (Cal. Cont. Educ. Bar Supp. 1974). The FTC requirement, however, is limited to "revenue which the franchisee must pay to the franchisor or its affiliate for the right to associate with the franchisor . . ." FTC GUIDES, *supra* note 6, at 5. Television advertising is clearly a condition of associating with the franchisor, but it is not a payment to the franchisor, and so may not be included in the fee payment determination.



the agreement's elements as FTC franchise elements. An agreement so characterized will be encompassed by the FTC rule regardless of the actual presence of the FTC franchise elements during the ongoing relationship.<sup>71</sup>

Second, the borderline franchisor should keep any controls or assistance in the distributor's operation of business to a minimum. The guidelines<sup>72</sup> suggest that controls or assistance which keep the reputation of the franchise at a high level (i.e., uniform controls) or which highly restrict the distributor in the operation of business will constitute "significant control or assistance."<sup>73</sup> Controls which restrict the distributor's business to a lesser extent and do not directly benefit the franchisor will have less of an impact.<sup>74</sup> These types of control or assistance should be kept to a minimum. The FTC excludes from consideration items which are not beneficial to the franchisor and which the distributor would be subject to regardless of the agreement.<sup>75</sup> The manufacturer, licensor, or wholesaler should feel free to put restrictions for the protection of a trademark into the agreement.<sup>76</sup> Borderline franchisors have to consider, of course, whether certain contractual restrictions are necessary to protect their investment or reputation. Persons contemplating a franchise agreement should keep in mind the risks involved with limiting control and weigh them against the costs involved in compliance with the FTC rule.<sup>77</sup>

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<sup>71</sup> See FTC GUIDES, *supra* note 6, at 2. "Any relationship which is represented either orally or in writing to be a franchise . . . is subject to the requirements" of the FTC rule. 16 C.F.R. § 436.2(a)(5)(1980).

<sup>72</sup> See note 19 *supra*.

<sup>73</sup> *Id.* The items specified as controls or assistance go to the heart of the franchisee's business operation. These restrict the franchisees in their method of operation by either controlling important aspects of the franchise operation or by providing assistance which franchisees are highly dependent upon.

<sup>74</sup> See note 19 *supra*. The items accorded less weight in the significant control determination do not go to the heart of the franchisee's operation. The items also do not go to create the appearance of a uniform operation.

<sup>75</sup> See note 20 *supra*. Items not considered as control are items which franchisees may already be subject to, e.g., health and safety restrictions, or items which do not give rise to benefit for the franchisor.

<sup>76</sup> See note 20 *supra*.

<sup>77</sup> For costs involved in complying with the rule, see notes 7 & 8 and accompanying text *supra*. Franchisors' benefits from control over franchisees' method of operation include assurance of quality and product service uniformity, and preservation of system image and goodwill. J. FELS, *FRANCHISING AND THE LAW* 12, 13 (1976).

Third, if the agreement does not contemplate a franchise fee, but does require the purchase of startup inventories, the quantity should be reasonable, and offered at bona fide wholesale prices.<sup>78</sup> Royalties, payments for services or goods and initial fees are considered in the franchise fee determination.

In order for an arrangement to be a "franchise" under the FTC rule, all three requirements for the package/product franchise must be present. By clearly eliminating one of the elements such as a franchise fee, the borderline franchisor can allow the use of a trademark and exercise "significant control or assistance" without the rule applying.

#### CONCLUSION

The new FTC franchise rule is an attempt to regulate an area of business which plays a key role in our economy and which has been the subject of much abuse. The FTC "franchise" definition must necessarily be vague and thus somewhat broad in order to encompass all business arrangements subject to franchise abuses. As this comment has pointed out, arrangements such as distributorships and trademark licenses constitute borderline areas in which the FTC franchise definition is difficult to apply.

Future litigation will eventually determine the scope of the FTC rule. For the present, however, franchisors must speculate on the rule's parameters. Both the cost of drafting a disclosure document and the penalties for noncompliance are high. Small franchisors should therefore weigh the risks involved with relinquishing control over franchisees against the costs of compliance with the rule. The purpose of this comment is to aid smaller businesses in making this determination.

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<sup>78</sup> See note 67 and accompanying text *supra*.