

Franchise Law



Regulation of the Franchise/Distribution Relationship: An Overview

Regulation of the Franchise/Distribution Relationship

While some jurisdictions regulate franchise sales, 23 states and territories have “relationship” statutes that regulate franchisor/supplier conduct in relationships with franchisees/dealers. These jurisdictions include:

- | | | |
|---------------|---------------|-----------------------|
| ■ Alaska | ■ Iowa | ■ North Dakota |
| ■ Arkansas | ■ Maryland | ■ Puerto Rico |
| ■ California | ■ Michigan | ■ Rhode Island |
| ■ Connecticut | ■ Minnesota | ■ U.S. Virgin Islands |
| ■ Delaware | ■ Mississippi | ■ Virginia |
| ■ Hawaii | ■ Missouri | ■ Washington |
| ■ Illinois | ■ Nebraska | ■ Wisconsin |
| ■ Indiana | ■ New Jersey | |

There currently is no federal law regulating the franchise/distribution relationship; however, bills intended to regulate certain aspects of these relationships have been periodically introduced in Congress without success during the past decade.

The Types of Business Relationships Regulated

As a general rule, a relationship will be subject to the restrictions outlined in these “relationship” statutes if it meets the definition of a franchise. Although that definition varies by jurisdiction, a business will generally be considered a franchise if it meets the following three criteria:

- The franchisee’s business is identified or substantially associated with the franchisor’s trademark.
- The franchisor exerts sufficient control over the franchisee’s business or there is interdependence between the franchisee’s business and the franchisor’s system. There are three different tests used to determine whether the franchisor exerts sufficient control:
 - First, the Federal Trade Commission uses the “significant control” or “significant assistance” test, which is applicable in the majority of the states. This test focuses on the franchisor’s level of control or assistance over the franchisee’s entire business.
 - Second, under the “marketing plan” test, which is used by several states, a franchise exists when the franchisor prescribes a marketing plan that the franchisee must follow.

- Third, under the “community of interest” test, which is used in a smaller number of states, a franchise exists when there is a sufficient level of interdependence between the franchisee and the franchisor.
- The franchisee is obligated to pay money to the franchisor or its affiliates for the right to engage in the business. Almost any monies paid to the franchisor or its affiliates can satisfy this element, except for the purchase of inventory at *bona fide* wholesale prices.

The relationship laws in a few jurisdictions—Connecticut, Missouri, Rhode Island, the Virgin Islands, and Wisconsin—define the covered relationships in a similar way but do not require the payment of any fees by the “franchisee.” As a result, these statutes generally cover distribution relationships in addition to traditional franchises. The same is true in Arkansas, New Jersey, and Puerto Rico, where the statutes govern most nonemployee relationships involving the distribution of goods and services. Delaware’s statute is similar to those of Arkansas, New Jersey, and Puerto Rico except that in most circumstances, it also requires a \$100 payment by the franchisee.

The Maryland and North Dakota statutes specifically exempt relationships covered by the state’s franchise registration law and only require repurchase of inventories when the relationship ends. Similarly, Alaska’s statute only applies to certain distribution relationships and does not apply to traditional franchise relationships.

Restrictions on Termination

All of these jurisdictions (except Alaska and North Dakota) restrict the franchisor’s/supplier’s right to terminate the relationship. Generally, it is unlawful for the franchisor/supplier to terminate the relationship without good cause. Although it is often unclear what constitutes good cause, the statutes generally provide that good cause includes any material violation of the parties’ agreement. These jurisdictions typically require that the franchisee/dealer receive advance notice of the termination and be given a specified period to cure any defaults before the agreement is terminated. Typically, a franchisee/dealer must receive between 30 and 120 days’ advance notice prior to termination.

Most of these jurisdictions also allow certain exceptions to the notice and cure requirements. Examples of when a franchisor/supplier may be excused from notice and cure requirements include the voluntary abandonment of the business by the franchisee/dealer, the bankruptcy of the franchisee/dealer, or the conviction of the franchisee/dealer for a crime related to his or her franchise/distribution business.

Restrictions on Nonrenewal

Many jurisdictions also restrict a franchisor's/supplier's right to choose not to renew the franchise relationship. These jurisdictions generally do not require that the parties' contract contain a renewal provision; however, if the contract does contain such a provision, such restrictions will apply.

The majority of these jurisdictions treat nonrenewal like a termination and require the franchisor/supplier to provide the franchisee/dealer advanced written notice of nonrenewal. These jurisdictions may also require good cause for nonrenewal. The jurisdictions treating nonrenewal in this manner include:

- Arkansas
- Connecticut
- Delaware
- Hawaii
- Indiana
- Iowa
- Maryland
- Minnesota
- Mississippi
- Missouri
- Nebraska
- New Jersey
- Puerto Rico
- Rhode Island
- Virgin Islands
- Wisconsin

A few states—Alaska, California, Illinois, Michigan, North Dakota, and Washington—generally only require repurchase of the franchisee's/dealer's assets or extended notice and a waiver of any noncompetition restrictions.

Repurchase Obligations

Several states require that the franchisor/supplier repurchase some or all of the franchisee's/dealer's furnishings, equipment, inventory, supplies, and other assets following the end of the relationship. Most of these states permit a franchisor/supplier to offset from the repurchase price any monies owed by the franchisee/dealer to the franchisor/supplier.

In Arkansas and California, the repurchase obligation is limited to a termination/nonrenewal that violates the relationship law. Hawaii, Maryland, and Washington require the repurchase of certain of the franchisee's/dealer's assets following any termination or nonrenewal. Alaska and Connecticut require essentially the same repurchase, but only following termination, and do not require repurchase for nonrenewal.

Wisconsin and Rhode Island's repurchase requirement is limited to inventories bearing the franchisor's/supplier's trademark. North Dakota limits the repurchase obligation to inventory sold to the franchised business before the franchisor/supplier can enforce a noncompetition restriction. Finally, Illinois, Iowa, and Michigan require repurchase of some of the franchisee's/dealer's assets following nonrenewal only in certain instances.

Transfer

A few states make it unlawful for a franchisor/supplier to refuse to permit a transfer of the franchise or dealership without good cause. These states include:

- Arkansas
- California
- Hawaii
- Indiana
- Iowa
- Michigan
- Minnesota
- Nebraska
- New Jersey
- Washington

The restrictions in the California and Indiana statutes only apply to certain transfers following the death of the franchisee/dealer. Many of these states permit a franchisor/supplier to have a right of first refusal to purchase the franchise or dealership prior to a transfer.

Other Restrictions

Several jurisdictions impose a variety of other restrictions on the franchise/distribution relationship, including:

- Arkansas, California, Hawaii, Illinois, Iowa, Michigan, Minnesota, Nebraska, New Jersey, Rhode Island and Washington make it illegal to prohibit free association among franchisees/dealers or to prohibit participation in a trade association.
- Hawaii, Illinois, Indiana, Minnesota, and Washington make it illegal for a franchisor/distributor to discriminate among similarly situated franchisees/dealers.
- Hawaii, Indiana, Iowa, and Washington limit the ability of a franchisor/distributor to require that supplies, inventories, goods and services be purchased from the franchisor/distributor or designated sources.
- Arkansas, Minnesota, Nebraska, and New Jersey require good cause before the franchisor/distributor can prohibit (or require) changes in the management of the franchisee/dealer.

Franchise Services

Wiley Rein LLP represents franchisors on matters for which they require expert legal services. We can:

- Determine whether your business concept is a franchise. If it is a franchise, but you would prefer to avoid the registration/disclosure requirements, we can help you to modify the business concept to avoid coverage by the franchise laws, if possible, or take advantage of applicable exclusions.
- Work with you to develop franchise and related agreements that will permit the growth of your concept while allowing you to maintain control.
- Seek federal registrations for your trademarks and provide assistance in maintaining and protecting those marks.
- Prepare the FDD and provide FDD compliance training to your franchise sales and franchise administration teams.
- Prepare and file all franchise registrations, exemptions, amendments and renewals in all applicable states.
- If you are a U.S. franchisor, assist you in developing your franchise concept abroad; if you are a foreign franchisor, assist you in bringing your franchise concept to the U.S.
- Help you understand your contractual rights and obligations and the statutory restrictions that apply to the franchise relationship, including transfers and contract renewals.
- Represent you in any proceedings brought by federal or state franchise regulators.
- Guide you in terminating the relationship with a franchisee without violating statutory restrictions.
- Represent you in litigation or arbitration proceedings with a franchisee.

For more information, please contact Franchise Group Chair Bob Smith at 202.719.4481.

This is a publication of Wiley Rein LLP and should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes. You are urged to consult your lawyer concerning your own situation and any specific legal questions.