

Legal Considerations In Expanding A Business Through Franchising

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Franchising can be an effective strategy to grow a business; however, one must consider its attendant legal implications. While, at first glance those legal issues may appear daunting, with proper guidance and some strategic planning, they can be managed in a relatively straightforward and efficient manner.

As an initial matter, it is important to understand what relationships fall within the definition of a "franchise." Generally, the following elements are required for a franchise relationship to exist: (1) the franchisee's business is substantially associated with the franchisor's trademark; (2) the franchisor exerts significant control over the franchisee's business or there is significant interdependence between the franchisee's business and the franchisor's system; and (3) the franchisee is obligated to pay money to the franchisor within a specific time frame. If the contemplated relationship meets this definition, it will be subject to the laws that regulate franchising.

In order to franchise a business, at a minimum, the following are necessary: (1) a registered trademark; (2) a franchise agreement; and (3) a franchise offering circular.

Registering A Trademark

For a franchise system to appeal to franchisees, the business and its trademarks must be recognized locally, regionally or nationally. For those considering franchising, a first priority should be to determine which trademarks the business will use and obtain federal registration of those trademarks.

In the United States, priority is given to the person who is the "first to use" the mark across state lines, rather than the person who is the "first to file" for registration of a mark. However, in order to ensure the greatest trademark protection, the marks should be registered with the United States Patent and Trademark Office. Registration provides certain rights, including the right to use the ® symbol; notice to third parties that the mark is being used and not available for registration; a legal assumption that the mark is valid; and federal court jurisdiction and statutory remedies.

The Franchise Agreement

To govern all aspects of the franchisor-franchisee relationship, franchise systems rely on various agreements, including area development agreements, franchise agreements, preliminary agreements, letters of intent, lease agreements and confidentiality agreements. In structuring agreements for a franchise system, one must consider the use and terms of franchise-related agreements. Agreements form the cornerstone of the franchise relationship and will be in place for a number of years, so their terms must be worded carefully to identify the parties' rights and obligations and anticipate events that might impact the parties in the future.

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While no two franchise agreements are identical, most include provisions such as the grant of a trademark license and the right to operate the franchised business, payment of fees, term of the rights, limitations on the use of the franchisor's trademarks, operational standards and specifications, restrictions on products and services that the franchisee may offer, reporting requirements, default, termination, post-termination obligations and restrictions on competition and disclosure of confidential information. Despite these commonalities, franchise-related agreements must be drafted to take into account the specifics of each system.

The Offering Circular

Disclosure Obligations. Since the FTC promulgated its 1979 Franchise Rule (FTC Rule), franchisors are required to provide a disclosure document (or offering circular) to prospective franchisees before offering or selling a franchise. The FTC Rule identifies 23 items that franchisors must include in their offering circulars, such as disclosures relating to the franchisor, the franchised system and the contractual relationship between the franchisor and the franchisee. The offering circular must contain a copy of all franchise-related agreements that a prospective franchisee must sign before opening the franchise. Effective July 1, 2007, franchisors must provide an offering circular to a prospective franchisee at least 14 calendar days before the franchisee signs the franchise agreement or pays any money to the franchisor, whichever is earlier.

The FTC Rule permits states to enact their own franchise laws; however, state statutes cannot provide less protection for franchisees than the FTC Rule. Fifteen states have franchise disclosure laws. A number of these laws require franchisors to make disclosures in addition to those required by the FTC Rule and prohibit franchisors from including certain provisions in franchise agreements (such as choice of forum, choice of law, mediation and arbitration, covenants not to compete and waivers of the right to associate, the right to a jury trial, or the right to seek punitive damages). Franchisors typically comply with these state-specific requirements by way of addenda to the offering circular and franchise agreements.

Registration Obligations. While the FTC Rule does not include a registration requirement, eleven states require franchisors to file their offering circular with the state and await the state's review and approval of the offering circular before offering to sell franchises in that state. These states are known as the "franchise registration states." Four additional states require only that franchisors deliver an offering circular to a prospective franchisee or that franchisors file an annual notice with the state before offering to sell franchises in that state.

In addition to the disclosure and registration requirements, nineteen states have laws that regulate some aspect of the franchise relationship. These "franchise relationship laws" restrict, among other things, termination, renewal and transfer of the franchise. The FTC Rule does not include any similar restrictions.

Liability for Violations. Franchisees cannot sue franchisors directly for a violation of the FTC Rule. However, the Federal Trade Commission may bring enforcement actions against franchisors seeking civil fines, criminal penalties, cease and desist orders, rescission and damages for violations of the FTC Rule. In addition, most state franchise laws permit franchisees to bring direct actions against franchisors for violations of the state statute, which may include offering or selling an unregistered franchise, failure to provide timely the offering circular or misrepresentation in the offering circular or during the sales process. The available remedies typically include damages, rescission of the franchise agreement and attorneys' fees. State franchise examiners can also issue cease and desist orders, require franchisors to offer rescission and impose fines for violations of state franchise laws. A franchisor's officers may be personally liable for such violations if they had knowledge of or participated in those violations. Franchisors must disclose violations of the FTC Rule and/or state franchise laws in the offering circular for at least 10 years, a significant concern for franchisors.

In addition to the basic disclosure, registration and delivery requirements, new franchisors should be aware of the following franchise-specific legal concerns.

Earnings Claims. In connection with buying a franchise, franchisees frequently ask questions relating to the potential earnings of a franchised unit. Unless franchisors have included the relevant earnings-related information in the offering circular, they cannot provide that information to a prospective franchisee. If an earnings claim is included in the offering circular, it must have a reasonable basis, include a description of its factual basis and the material assumptions underlying its preparation and presentation and, except in limited circumstances, be based upon historical information.

Financials and Auditor's Consent. Franchisors must include audited financial statements in the offering circular. Typically, the audited financial statements will need to be dated within 90 days of the date of the offering circular. If the audited financials are older, the franchisor must include current unaudited financials. In addition, a number of registration states require consent from an auditor to include the financial statements in the offering circular. In the wake of recent accounting scandals, auditors are undertaking a more detailed review of the offering circular and, in some instances, have required franchisors to make changes to the offering circular. Auditors' preparation of audited financial statements and review of the offering circular can be expensive and time consuming.

Advertising Approval. Eight states require that all advertising of franchise offerings be filed with the state before use. Generally, any published communication directed to a prospective franchisee that discusses the sale of a franchise is

considered advertising. Most of these states also restrict the types of claims that can be made in advertisements, including prohibitions against referring to the franchise as a safe investment or implying that state registration of the offering circular constitutes state approval. In addition, when a public figure is used in franchise advertising, the franchisor must disclose whether the public figure is being compensated.

Sales Agent Registration. Nine states require franchisors to register any employee who is involved with selling franchises prior to that person commencing sales activities in the state. Franchisors must file a Sales Agent Disclosure Form for each sales agent, which includes the sales agent's home and business addresses and telephone numbers, social security number, date of birth, five-year employment history and information about certain litigation matters (including bankruptcies).

If the sales agent is not an employee of the franchisor, three states require the franchisor to file more detailed information about the sales agent. These states additionally require the sales agent to have a license from the state prior to engaging in franchise sales activities in the state.

Renewal of the Registration. Once an offering circular is completed and, if necessary, filed and approved by the states, generally, it is valid for a one-year period; however, a number of registration states tie the effective period of an offering circular to the franchisor's fiscal year end. Prior to the expiration date of the registration, information in the offering circular must be updated as of fiscal year end. Once the updated offering circular is prepared, it can immediately be used in the non-registration states; however, before it can be used in the registration states, the updated offering circular must be filed with and approved by each registration state. If a registration state does not approve the updated offering circular prior to the expiration date, the franchisor will go "dark" in that registration state, which means that the franchisor cannot sell franchises in that state until the offering circular has been prepared, filed and approved by the respective state.

Amending the offering circular. An offering circular must be amended if there has been a "material change" to any information in the offering circular, including any change that may impact a prospective franchisee's decision to purchase a franchise. Examples include negative changes in financial statements, changes in the franchise program, a significant decrease in the number of company or franchised units and significant litigation matters.

Business Opportunity Laws. In addition to complying with the state franchise laws discussed above, a franchisor may need to comply with several state "Business Opportunity Laws." These laws, which vary from state to state, regulate, among other things, "get rich quick" schemes and require certain franchisors to file a notice with the state.

The legal considerations identified above are not intended to be a comprehensive list of all the issues to be considered before franchising a business. Once the decision has been made to franchise, consult with an attorney who has franchising experience.

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