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The Reluctant Franchisor

Due to the heavily-regulated nature of franchising, clients often tell their attorneys "I'm only going to do a license. I don't want to do a franchise." Although a client may believe what he says, he's most likely drawing a conclusion that disregards the facts and/or the law.

What is a Franchise?

A "franchise" is defined differently under the federal franchise rule from how it is defined under state laws. The definition of a "franchise" also varies from state to state. Under the federal franchise rule, if all of the following elements are present, then the business relationship constitutes a franchise:

- The franchisee will obtain the right to operate a business (or to offer, sell or distribute goods, services or commodities) that is identified or associated with the franchisor's trademark
- The franchisor will (or has the right to) exert significant control over the franchisee's business or provide significant assistance in the franchisee's business
- The franchisee makes (or promises to make) a required payment to the franchisor (or its affiliate)

However, if those three elements are present, the business relationship constitutes a franchise regardless of whether the franchisor calls it by another name or denies that it is a franchise, regardless of whether the parties agree that it is not a franchise and regardless of whether the parties attempt to have the franchisee waive the application of the franchise laws. If it walks like a duck and talks like a duck, it's a duck.

After I explain the three requisite elements to a client, we typically discuss restructuring the business relationship in various ways to avoid application of the franchise laws. What if we eliminate the trademark license? What if there is no significant control or assistance? What if there is no required payment? Typically, none of those alternatives is acceptable, as the resulting business relationship does not satisfy the client's objectives.

What Must Franchisors Disclose to Prospective Franchisees?

The purpose of the franchise laws is to provide certain required information to a prospective investor so that he can make an informed decision whether or not to invest in a franchised business.

Under the federal franchise rule, a Franchise Disclosure Document must be provided to a prospective franchisee at least 14 days before the franchisee signs the Franchise Agreement or gives the franchisor any money or other consideration. The Franchise Disclosure Document

contains 23 specified categories of information that must be included. The information falls into two categories:

- Information about the franchisor and the franchise system, such as what business the franchisee will actually be conducting, the biographical, litigation and bankruptcy background of the franchisor and its management team and the financial condition of the franchisor
- A plain-English summary of the key provisions of the Franchise Agreement, such as what the franchisor will be providing for the franchisee (such as training), the fees the franchisee must pay to the franchisor or its affiliates and what the franchisee must buy from the franchisor or its affiliates or approved vendors and suppliers.

The Franchise Disclosure Document also contains the Franchise Agreement and all of the other agreements that franchisees must sign in connection with becoming a franchisee.

Why Comply with the Law?

Compliance with the federal franchise rule is not as difficult or burdensome as potential franchisors fear and offers certain advantages. First, regardless of whether the franchisor acknowledges that the business relationship is a franchise, the franchisor should have a solid agreement that clearly states the parties' respective rights and obligations and protects the franchisor's interests. Second, business relationships that do not comply with the federal franchise rule frequently constitute business opportunities, which are perceived to be less legitimate than franchises and must comply with the federal business opportunity rule and a patchwork of 26 state business opportunity laws.

The failure to comply with the federal franchise rule and state franchise laws may subject the franchisor, its officers and directors and other personnel to severe federal and state civil and criminal penalties. In addition, it reflects poorly on the franchisor, as the franchisee rightfully questions whether the franchisor, in addition to disregarding its legal obligations, will disregard its contractual obligations or otherwise cut corners in business.

Susan E. Wells is a partner with the Phoenix law firm of Wells & Gerstman PLLC. Her corporate and business practice encompasses all aspects of business transactions and commercial relationships in numerous industries, including franchising and buying and selling businesses.

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