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The "Fractional Franchise" Exemption from Franchise Law Requirements

The purpose of the franchise disclosure laws is to provide certain required information to a prospective franchisee so that he can make an informed decision whether or not to invest in a franchised business. Unless an exemption from the disclosure requirements of the franchise disclosure laws applies to the franchise transaction, a Franchise Disclosure Document (FDD) must be prepared and provided to a prospective franchisee before the franchisee signs the Franchise Agreement or gives the franchisor any money or other consideration. If one of the exemptions from the Federal Trade Commission's (FTC) federal franchise rule applies, the franchisor does not have to provide a FDD to prospective franchisees.

The following is a discussion of the "fractional franchise" exemption from the federal franchise rule, as well as a discussion of the availability of matching exemptions under state franchise laws.

Federal Law

The fractional franchise exemption contained in the FTC's federal franchise rule applies if:

● The franchisee[1] has more than two years' experience in the same type of business[2] AND

● The parties[3] have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20% of the franchisee's total dollar sales volume during the first year of operations

Some of the Starbucks® operations in supermarkets and some of the Subway® operations in convenience stores are examples of fractional franchises. The model assumes that the fractional franchisee (such as the supermarket or convenience store) is adding an extra line of products or services to an existing operation.

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[1] If the franchisee does not have the required business experience, the experience of current directors, officers, general partners and LLC managers of the franchisee or its affiliate may satisfy this requirement. If the franchisee and those people do not have the required business experience, a person with that experience can be hired before the transaction takes place.

[2] The "same type of business" requirement is satisfied if the franchisee sells competitive goods or services or is engaged in a business that ordinarily would be expected to sell the type of goods or services to be distributed under the franchise.

[3] Although the burden is on the franchisor to prove the applicability of the fractional franchise exemption, both the franchisor and the franchisor must be capable of making a reasonable good faith determination of the franchisee's projected revenue, based upon their respective analyses of historical and projected earnings, a market analysis and/or otherwise.

The FTC reasons that the protections from fraud of FDD disclosure are not necessary because the franchisee is sophisticated enough to do its due diligence, negotiate the relationship and otherwise protect itself. In addition, because the franchise operations would be a small (but not insignificant) percentage of the franchisee's operations, franchisee's dependence upon the franchisor's expertise, and the potential impact on the franchisee, are not be as great in a fractional franchise context as they would otherwise be.

State Law

Laws vary from state to state.[4] Some states have franchise disclosure and/or registration laws; others do not. Some states have registration requirements; others only have disclosure requirements.

California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin all have franchise disclosure laws. All of those states other than Michigan and Oregon require registration with state regulators.

Of the states that have franchise disclosure laws, Illinois, Indiana and Virginia exclude fractional franchises from the definition of a "franchise." Therefore, in addition to the disclosure and registration requirements of those states' franchises laws being inapplicable, the other statutory provisions of the franchise laws (such as antifraud provisions and relationship laws) are inapplicable.

California, Michigan, Minnesota, New York, Oregon, South Dakota and Wisconsin have fractional franchise exemptions. Meeting the conditions for application of a state's fractional franchise exemption eliminates the franchisor's obligation to register the franchisor's franchise offering with state regulators and, except in New York, to deliver an FDD to prospective franchisees. However, in California and New York, franchisors must make an exemption filing; in California, the filings must be renewed annually. In Michigan, a franchisor must nevertheless deliver an FDD to prospective franchisees if the franchisor has prepared an FDD for use in another state.

Most states' definitions of fractional franchise vary from the federal definition. For example, Virginia's fractional franchise exclusion requires that sales of goods and services account for less than 20% of a retailer's gross sales, eliminating the two years' experience requirement and application of the exclusion to wholesalers. California and New York require that the franchisee not be controlled by the franchisor. California, Michigan and New York require that the

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[4] Several additional states that do not have franchise registration or disclosure laws have other franchise laws, including relationship laws that govern franchisors' rights to terminate or refuse to renew franchises and other matters. All states have other laws that may affect a franchise offering and the relationship between franchisors and franchisees, such as laws relating to antifraud, misrepresentation, sales representatives, dealerships and distributors.

In addition, compliance with federal and state franchises laws frequently provide an exemption from state business opportunity laws. Certain state exemptions from business opportunity laws may not be available if the franchisor relies upon the fractional franchise exemption from federal or state franchise laws. Although certain states' business opportunity laws do not apply to franchisees that are already in business, each state's laws should be reviewed.

projection of less than 20% of the franchisee's total dollar sales volume apply during each year of their relationship, not only the first year; Virginia requires that the 20% figure be actual, not projected.

States' definitions relating to management personnel's experience also vary. Some states require that the franchisee's experience must be recent; other states don't specify a timeframe. Some states limit the people whose experience qualifies for the exemption. For example, all of these states' laws differ from federal law in that they require the franchisee's designated management personnel to have the requisite experience, not an affiliate's management personnel. Some states require that the experienced management personnel's experience be with the franchisee, not a third party.

States' definitions relating to "same type of business" vary as well. Although the federal law does not focus on the location of existing operations or the new franchised unit, some state laws require that the existing operations and the new franchised unit have the same location.

Hawaii, Maryland, North Dakota, Rhode Island and Washington do not have fractional franchise exclusions or exemptions. In those states, discretionary exemptions granted on a case-by-case basis or other exemptions must be relied upon. For example, in Maryland, discretionary exemptions from the registration and disclosure requirements will typically be granted for transactions that meet the FTC's fractional franchise exemption; however, Maryland's antifraud provisions will still be applicable.

Potential Risks and Other Issues relating to Reliance upon the Fractional Franchise Exemption

1. The burden of proving the applicability of the exemption is on the franchisor.

2. The exemption is only available in certain states. Therefore, the franchisor cannot offer or sell franchises in certain states unless another exemption is available or the franchisor complies with applicable disclosure and/or registration requirements.

3. The details of the exemption vary from state to state. Before entering into any state, the franchisor should confirm the requirements of the exemption and the impact of compliance. In addition, the franchisor should confirm whether the business opportunity laws in each state are applicable and the impact of other laws in each state.

4. The definition of "same type of business" is ambiguous. Although the FTC has stated that a hardware store expanding through a franchised operation into lawn care equipment sales satisfies the definition, the FTC has also stated that a muffler shop expanding into a quick-lube franchised business would not satisfy the definition. Similarly, the FTC has stated that the operation of a fast food kiosk would not be the same type of business as a large sit-down, full-service restaurant. The distinction is not necessarily clear.

Practical Guidance

A franchisor must accept that some states do not have a fractional franchise exemption and that some potential franchisees will not meet the fractional franchise criteria. If a franchisor cannot accept those restrictions, it should not limit itself to relying upon the fractional franchise exemption.

To minimize the risk relating to relying upon the fractional franchise exemption, a franchisor must exercise due care and act in good faith. It should implement and strictly comply with the systems necessary to make sure, to the extent possible, that the requirements of the federal exemption and the relevant state exemption are satisfied before granting a franchise.

Among the measures that a franchisor should implement are the following:

1. Have the prospective franchisee provide the franchisor with historical financial statements verifying historical sales revenue of its existing business.

2. Have the prospective franchisee prepare and provide the franchisor with projections of combined sales revenue for the first year of operations and, in certain states, on a continuing basis. (The franchisor should not correct or comment on the franchisee's projections, as those comments would constitute financial performance representations on which the prospective franchisee could sue the franchisor if the projections were inaccurate.)

3. The franchisor must determine whether or not the prospective franchisees' projections are reasonable and whether the prospective franchisee's projected sales revenue generated from the its existing business will be at least 80% of its projected combined total revenue for the first year of operations.

4. Have the prospective franchisee provide the franchisor with financial statements verifying historical sales revenue of the combined business after the first year of operations and, in certain states, on a continuing basis.

5. Retain all of these documents and franchisor's analysis of its determination of reasonableness and projected total revenue indefinitely.

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 representing franchisors, franchisees and landlord in connection with their leases with franchisees.