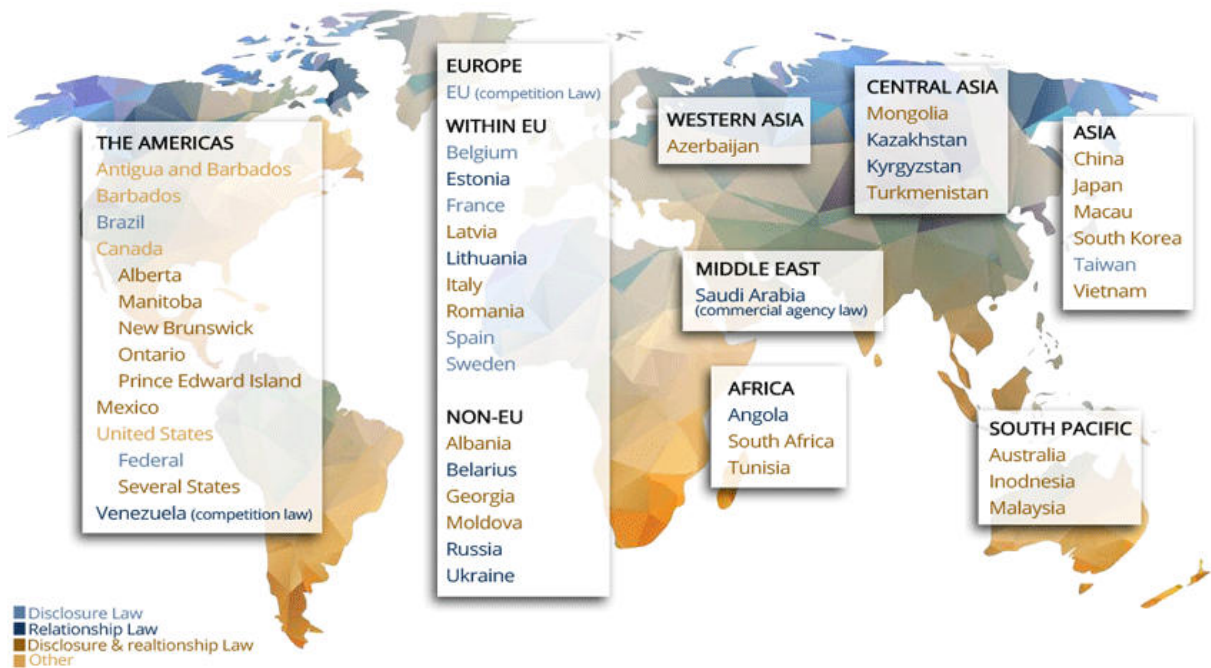




INTERNATIONAL RESOURCES ABSTRACT

Laws and agencies that regulate the offer and sale of franchises



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Which laws and government agencies regulate the offer and sale of franchises?

The FTC regulates franchises under federal law. The FTC also has a Business Opportunities Rule that applies in the relatively rare situation where there is no written franchise agreement or where the total of the required payments or commitments to make a required payment to the franchisor or an affiliate of the franchisor that are made at any time from before to within six months after commencing operation of the franchisee's business is less than US\$540. Since it is rare that a franchise programme falls within the FTC Rule definition of a business opportunity venture, this discussion will not cover such ventures.

The FTC Rule requires disclosure by franchisors before any offer or sale is made, unless an exemption applies. The FTC Rule does not govern the ongoing franchisor-franchisee relationship. Rather, it only imposes pre-sale disclosure requirements and does not require any registration or filing. In addition, 14 states have laws regulating the offer and sale of, and requiring pre-offer filings or registration of, franchises, as well as imposing pre-offer and pre-sale disclosure requirements. They are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. Oregon regulates offers and sales, but requires no filing. In addition, 21 states, as well as the District of Columbia, Puerto Rico and the US Virgin Islands, have statutes that regulate the terms of the franchisor-franchisee relationship. These states are: Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. The areas of primary concern under state relationship laws are the termination, renewal and transfer of franchise rights.

Generally, state franchise statutes apply when:

- the offer originates within the state;
- the offer is directed by the franchisor to a prospective franchisee within the state or to a resident of that state;
- the offer is received within the state;
- meetings between the franchisor and prospective franchisee occur in the state; or
- the franchised business will be operated in, or the franchise territory is, entirely or partially in the state.

However, these jurisdictional factors vary by state, so franchisors need to be aware of the possible application of multiple states' franchise laws. In addition, approximately half of the states have 'business opportunity' laws that require similar registration or disclosure procedures. Exceptions from them are usually available to franchisors who license a registered trademark. However, exemption filings must be made in certain states in order to qualify for the exemptions.



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What are the exemptions and exclusions from any franchise laws and regulations?

The FTC Rule exempts lease arrangements in which an independent retailer sells its own goods and services from premises leased from a larger retailer in that retailer's store, instances where a franchisee is required to pay less than US\$540 before or during its first six months of operations, oral franchise agreements, and 'fractional' franchises. In addition, the FTC Rule exempts petroleum marketers and resellers covered by the Petroleum Marketing Practices Act. It also contains the following three exemptions, collectively referred to as the 'sophisticated investor exemptions':

- ⌚ large investment exemption, which exempts franchise sales where the initial investment is US\$1,084,900 exclusive of unimproved land and franchisor financing;
- ⌚ large franchisee exemption, which exempts franchise sales to ongoing entities with net worth of at least US\$5,424,500 and five years of prior business experience; and
- ⌚ insiders' exemption, which exempts franchise sales if one or more purchasers of at least a 50 per cent ownership interest in the franchise has been, within 60 days of the sale, and for at least two years, an officer, director, general partner, individual with management responsibility for the offer and sale of the franchisor's franchises, or the administrator of the franchised network; or who has been, within 60 days of the sale, for at least two years, an owner of at least a 25 per cent interest in the franchisor.

Many of the FTC Rule exemptions do not have correlating exemptions under state franchise disclosure laws, but some state laws do have similar exemptions.

Some of the exemptions or exclusions of most interest to franchisors available under state franchise registration or disclosure laws include, but are not limited to:

- ⌚ large franchisors or experienced franchisors who exceed a specified net worth and who have had a minimum number of franchisees for a minimum period of time;
- ⌚ offers or sales that are renewals, extensions, or substantially similar to franchises already owned by the franchisee;
- ⌚ certain sales of a franchise by a franchisee or a sub-franchisor; and
- ⌚ offers or sales to a financial institution or life insurance company.

Not all states have any or all of these exceptions, and they often apply only to registration, not disclosure. Because the FTC Rule applies to all states, an exemption under state law will not relieve a franchisor from its obligation under the FTC Rule to a prospective franchisee. Similarly, a franchisor may be exempt under the FTC Rule but still have to comply with a state franchise law.

Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

A franchisor must be in compliance with any applicable state registration and disclosure requirements before that franchisor may offer franchises.



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Are there any laws, regulations or government policies that restrict the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers?

No, except to the extent implied by answers to other questions.

In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the subfranchisor?

Under the FTC Rule, if a sub-franchisor sells a franchise, it is jointly responsible with the franchisor for compliance with all franchise disclosure laws. Additionally, registration states require separate registration by the franchisor of the offer of sub-franchise rights and separate registration by the sub-franchisor of its offering of subfranchises.

Is there any obligation for continuing disclosure?

The purpose of the disclosure document is to provide information to persons and entities who are considering the purchase of a franchise. Thus, there is no requirement to provide disclosure documents on an ongoing basis to existing franchisees. However, subject to a number of exceptions, exemptions and qualifications, there is often a requirement to provide a disclosure document to an existing franchisee who is purchasing an additional franchise or renewing an existing one.

How do the relevant government agencies enforce the disclosure requirements?

The FTC is responsible for enforcement of the FTC Rule. Following investigation, the FTC may commence an enforcement action against a franchisor if a violation is discovered. Enforcement usually occurs through a court order, which will contain injunctive provisions enjoining the franchisor from continuing the violation.

Moreover, all of the state registration and disclosure statutes create their own enforcement structures. These statutes vest investigatory and prosecuting power in the state administrator. Also, state administrators have the authority to issue ex parte stop orders prohibiting franchise sales activities by individuals or entities whom the state administrator believes may be violating the franchise statute until a hearing can be conducted. Some state franchise statutes provide for criminal enforcement and private rights of action. Criminal enforcement on the state level usually occurs through the state attorney general's office. Some have their own specialised franchise investigators. While certain states' franchise laws also contain provisions that allow for criminal penalties for violations, they are rarely utilised.



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In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The general common law of fraud and misrepresentation applies to the offer and sale of franchises. Furthermore, most states have statutes that prohibit unfair and deceptive practices.

General contract, antitrust and fair-dealing principles affect the offer and sale of franchises. The Sherman Act, the Robinson-Patman Act, the FTC Act and the Clayton Act prohibit anti-competitive abuses in contract formation as well as general trade and commerce. These laws are also applicable to franchises. Moreover, federal civil rights statutes may apply if the franchisee can show prohibited discriminatory practices in the offer, sale, renewal or termination of a franchise. There are private franchise associations that have established codes of conduct for their members. However, these do not have the force of law .

Do other laws affect the franchise relationship?

There are no federal franchise relationship laws of general application. However, certain industries (for example, the petroleum industry, via the Petroleum Marketing Practices Act) are regulated by industry-specific legislation. Business opportunity laws may also apply, and exceptions or exclusions available under them require franchisors' attention. In addition, several common law theories are also relevant to the franchise relationship; in the absence of franchise relationship laws, franchisees who suffer wrongful acts by franchisors can bring actions based on theories such as breach of contract, fraud, misrepresentation and antitrust. Finally, courts consistently hold that the implied covenant of good faith and fair dealing that exists in any commercial contract also exists in franchise agreements. However, the scope of, and the manner of application of, the implied covenant of good faith and fair dealing has been the subject of much litigation and debate.

In addition, it should be noted that the franchisor–franchisee relationship can be implicated in disputes involving third parties. Examples include claims by parties who assert injuries suffered by virtue of acts of commission or omission by franchisees or their employees (raising issues of potential vicarious liability of franchisors); claims by putative transferees, who assert injury because the franchisor disapproved a proposed transfer (which may also include an assertion of tortious interference); and suppliers who assert injury because the franchisor refused to approve them, or withdrew approval.



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