Danish-American Business Forum

Product Distribution in the United States: A Common Market—or Balkanization?
By **Michael J. Lockerby**

Mr. Lockerby is a partner in the law firm of Foley & Lardner LLP, based in the Washington D.C. office, and a leader of the firm's national Distribution & Franchise Practice Group.

For companies based overseas, the seemingly wide open U.S. market has long been attractive. Part of the attraction has been that—compared to Europe before currency unification and other developments in the EU—the borders separating the 50 states have not had the commercial equivalent of "checkpoints." But when selling branded products in many U.S. states, manufacturers may face some unforeseen barriers on a state-by-state basis. These barriers may be more restrictive than what Danish suppliers customarily face in Europe. And these barriers are relatively unknown, even to many American companies and their legal advisers. These hazards to commercial navigation take the form of federal and state regulation of "franchises."

Franchises? Isn't a "franchise" one of the American icons like McDonald's or Holiday Inns? What does "franchise" law have to do with the distribution of products in the U.S.? For better or worse, the answer is that these U.S. laws may alter—and in some cases impair—the rights and obligations of manufacturers whose products are sold through distributors, dealers, value-added resellers ("VARs"), licensees and other independent outlets.

A comprehensive survey of these laws would be as lengthy as the Copenhagen telephone directory. But every Danish company that sells its products in the U.S.—or licenses the manufacture or sale of products under its trademark in the U.S.—should at least have these federal and state franchise laws on its corporate "radar screen."

This article therefore answers the following questions:

1. What are the consequences of being subject to federal and state franchise laws in the U.S.?
2. What types of product distribution arrangements are subject to the franchise laws?
3. Is it possible to structure distribution arrangements to avoid application of the franchise laws?

<u>Consequences of Being a "Franchise"</u>

The fact that an agreement or arrangement is called a "distributorship," a "dealership," a "sales agency," a "VAR," or a "license" does not exempt it from U.S. franchise laws at the federal and state level. If a relationship is deemed to be a "franchise," that determination has two types of consequences. The first is upfront, before the contract is signed. The second is after the fact, once the arrangement is in place.

Upfront, before offering a "franchise," the company granting the distribution rights or license must provide the prospective "franchisee" with a Franchise Disclosure Document or "FDD." The FDD is required by the U.S. Federal Trade Commission ("FTC") under its Franchise Disclosure Rule. The form and substance of the FDD is much like a securities offering circular. It must contain warnings about the risks of entering into the "franchise." The FDD also must contain detailed information about the supplier (the "franchisor"). This required information includes audited financial statements, background about company's officers and litigation history, the competitive marketplace, and the costs of entering into the business. The "dos" and "don'ts" of what must be said—and what must not be said—in the Franchise Disclosure Document are prescribed in excruciating detail by the FTC Franchise Disclosure Rule.

In approximately a dozen states, provision of the FDD in accordance with the FTC Franchise Disclosure Rule is necessary but not sufficient to comply with state law. In the dozen or so "registration states," the franchisor must file a registration with state regulators and—with one exception—obtain their approval before providing the FDD to prospective franchisees or otherwise offering a franchise. The "registration states" include California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Michigan is sometimes identified as a "registration state." Technically, it is not, however. The Michigan Franchise Investment Law merely requires filing of a notice of intent to do business in the state and to comply with disclosure obligations.

Once the distribution arrangement is in place, it may also be subject to franchise "relationship" statutes of general applicability enacted in nineteen states (plus the District of Columbia, Puerto Rico, and the Virgin Islands). In these jurisdictions, various contractual provisions may be "trumped" if the distribution agreement satisfies the statutory definition of a "franchise." Some state "relationship" laws apply to distributorships and dealerships that might not constitute "franchises" for purposes of disclosure and registration requirements. Common provisions of these state franchise "relationship" laws:

1. Permit termination only for "good cause";
2. Mandate a certain form of notice of termination, a minimum amount of advance notice, and even an opportunity to cure;
3. Require "good cause" for contractual amendments or changes in "competitive circumstances"; and
4. Require the repurchase of unsold inventory upon termination.

If these state "relationship" laws apply, certain provisions of the distributorship or dealership agreement may be unenforceable or even illegal. But those consequences may be the least of the supplier's worries.

For violation of the FTC Franchise Rule, the consequences can include:

1. "Cease and desist orders";
2. TROs, preliminary injunctions, and permanent injunctions—including prohibitions against advertising, promoting, offering, or selling ***any*** franchise;
3. Rescission of the contract (permitting the "franchisee" to recover everything invested in the relationship), reformation (in other words, rewriting) of contracts, refunds, damages, and public notices;
4. Civil penalties; and
5. Compensatory damages, treble damages, costs, and attorneys' fees under various state "little FTC Acts."

For example, the North Carolina Unfair Trade Practices Act is one of many such "little FTC Acts" that allow private plaintiffs to recover treble damages for violations of the FTC Franchise Disclosure Rule. In 1997, the plaintiffs in a franchisee class action in Charlotte, North Carolina obtained a $590 million judgment under the North Carolina little FTC Act for failures to make certain disclosures. The judgment was against not only the U.S. franchisor but also against the parent company in the UK and the company's officers and directors individually. That judgment was ultimately reversed on appeal. Still, it demonstrates the risks associated with alleged failures to make disclosures required by franchise laws.

For violation of state franchise registration laws, aggrieved franchisees can obtain rescission of the "franchise" agreement, damages, and costs and attorneys' fees. Under certain circumstances, violation of state franchise registration laws may be punishable as a crime.

In states with relationship laws that restrict terminations, non-renewals, or "changes in competitive circumstances," the aggrieved "franchisee" can recover compensatory damages (sometimes expressly including loss of goodwill and lost profits), punitive damages, injunctive relief (sometimes including preliminary injunctive relief without a showing of irreparable harm), and costs and attorneys' fees. At least five states also impose criminal penalties for violation of their relationship laws.

<u>Definition of a "Franchise"</u>

Many U.S. companies—and even U.S. lawyers, for that matter—react violently to the suggestion that product distribution relationships may, in the eyes of the law, be considered a "franchise." Common objections include the following:

1. "Everyone else in our industry does it this way."
2. "We grant licenses, not franchises."
3. "We don't call it a franchise."
4. "We're partners, really." "We don't tell our licensees how to run their business."
5. "They use their own trade name, not ours."
6. "We don't make them buy anything from us."
7. "They sell other products or services besides ours."

Suffice it to say that many U.S. companies—and their lawyers—have had some unpleasant surprises in litigation. For example:

1. An insurance agency was protected against termination without "good cause" by the Connecticut Franchise Act and the Connecticut Unfair Trade Practices Act.
2. An exclusive distributor of pantyhose in Lithuania was protected from termination by the New Jersey Franchise Practices Act because the distributor was incorporated in New Jersey.
3. An exclusive distributor of slot machines in New Jersey was protected from termination by the New Jersey Franchise Practices Act.
4. A distributor of computer hardware and software was protected from termination, nonrenewal, or amendment of its "franchise" by the New Jersey Franchise Practices Act.

5. A photocopier distributor was protected from nonrenewal by the Indiana Deceptive Franchise Practices Act.
6. A contract for the operation of a boat dealership that was otherwise terminable at will upon 30 days' notice was found subject to the California Franchise Relations Act.
7. An office furniture dealer was protected from termination by the Missouri Franchises Law.
8. A distributor of dictation machines was protected from termination by the New Jersey Franchise Practices Act.
9. A muffler dealer was entitled to rescind its lease because the dealership (including the lease) had been offered in violation of the Minnesota Franchises Law.
10. A candy distributor was entitled to seek treble damages and attorneys' fees because its distributorship had been offered in violation of the Washington Franchise Investment Act.
11. The North Dakota Securities Commissioner secured a cease and desist order against the offering of distributorships for the sale of dry milk because they were deemed to be unregistered franchises in violation of the North Dakota Franchise Investment Law.

Neither an adverse jury verdict nor the imposition of fines or penalties is the ideal method for determining whether a relationship that the parties have called something else—such as a "distributorship," a "dealership," a "sales agency," a "VAR," or a "license"—is in fact a "franchise." It is obviously preferable to have U.S. counsel determine whether a distribution relationship is in fact a "franchise" ***before*** the company establishes a distribution relationship that might be subject to the disclosure requirements of the FTC Franchise Rule or the franchise disclosure and registration requirements of certain state laws. U.S. counsel should also make such a determination ***before*** the company terminates, fails to renew, amends, or "changes the competitive circumstances" of a distribution relationship that is a "franchise" within the meaning of various state "relationship" laws of general applicability.

Although the statutory definitions of "franchise" vary, there are two or three common elements of most definitions. The first element, the trademark element, is typically satisfied by either a license to use or some form of association with the franchisor's trademark. The second element is some form of "assistance or control." The FTC Franchise Rule requires "significant" franchisor assistance to or control over the franchisee's business for this second element to be satisfied. In thirteen states, this second element is satisfied where goods or services are sold pursuant to a "marketing plan" prescribed by the franchisor. Other states find this element to be present where the franchisor and franchisee share a "community of interest" in the marketing of trademarked goods or services. The franchise "relationship laws" of Arkansas and Delaware define "franchise" yet another way. The third element, a "franchise fee," is some form of payment for the right to operate the franchised business.

Unfortunately, each of these three elements can be established based on contract provisions that are common in most distribution relationships.

Trademark Element

Under the FTC Franchise Rule, the ***mere possibility*** that a "distributor," "dealer," "licensee," "VAR," "sales representative," or "sales agent" ***could*** use the manufacturer's trademark suffices to establish a trademark license for purposes of the definition of "franchise." Under various state laws, courts have found the requisite trademark license or association with a franchisor's trademark under the following circumstances:

1. A distributor of computer hardware and software operated under its own trade name and did ***not*** use its supplier's name on stationery, business cards, or signs. The New Jersey Supreme Court nevertheless found a trademark license because the distributor was authorized to use the supplier's trademark and was obligated to use its "best efforts" to maintain and promote the supplier's name, trademark, and logo on the products.
2. A distributor was granted a territory for the sale of trademarked products.
3. A management agreement granted the right to use a trade name in marketing buyers' club memberships.
4. A distributor was licensed to use a manufacturer's trademark, was encouraged to associate his business with the trademark, and displayed the manufacturer's trademark at his business and on stationery.
5. A dealer was entitled to call itself an authorized dealer of the products of the manufacturer, which helped pay for Yellow Pages advertisements listing the dealer as being authorized.

"Assistance or Control"

Under the FTC Franchise Rule, ***any one*** of the following suffices establish "significant" assistance or control:

1. Restrictions on business location, customers, or sales area;
2. Furnishing management, marketing, or personnel advice;
3. Formal sales, repair, or business training programs;
4. Furnishing a detailed operations manual;
5. Promotional campaigns requiring participation or financial contribution;
6. Mandatory personnel policies and practices;
7. Control over production techniques;
8. Establishing accounting systems or requiring accounting practices;
9. Location and site approval;
10. Location design or appearance requirements; or
11. Control over hours of operation.

In states that define franchise in terms of a "marketing plan prescribed in substantial part" by a franchisor, courts have found this element to be satisfied under the following circumstances:

1. A dealer was required to advertise the manufacturer's products intensively, conduct a variety of promotions, and carry the manufacturer's array of accessory sales devices.
2. Distributors marketed products pursuant to a comprehensive advertising and promotional program developed by the supplier, and the supplier reserved the right to screen and approve all promotional materials used by distributors.
3. A distributor was required to perform warranty service in accordance with the manufacturer's warranty policy, to send representatives to sales meetings, to have his service personnel factory trained by the manufacturer, to maintain certain levels of

inventory, to hire an extra salesman, and to provide periodic sales reports to the manufacturer.

The Commissioner of the California Department of Corporations has issued various opinions finding the presence of a marketing plan in light of the following provisions in an agreement:

1. "Prescribing or limiting resale prices";
2. "Restrictions on use of advertising or mail order business";
3. "Requiring display racks";
4. "Giving detailed directions and advice concerning operating techniques";
5. "Assigning exclusive territory";
6. "Providing for uniformity or distinctiveness of appearance";
7. "Limiting sale of competitive products";
8. "Limiting use of products";
9. "Requiring approval of advertising and signs";
10. "Prohibiting engaging in other activities";
11. "Providing training sessions";
12. "Assigning contract";
13. "Use of manual"; and
14. "Providing 'trade secrets.'"

In one state (New Jersey) that defines franchise in terms of a "community of interest," courts have found this element to be satisfied under the following circumstances:

1. The distributor was obligated to maintain at least four full-time sales representatives, to promote and sell its supplier's products, and to submit monthly sales forecasts.
2. The supplier had the right to inspect the distributor's books and records.
3. The supplier trained its distributor's personnel and imposed restrictions on the way in which it marketed certain products.
4. The supplier controlled the quality of its distributor's services by requiring the distributor to prepare the customer site for installations in accordance with the supplier's specifications and to maintain training programs for end users.
5. The supplier and its distributor cooperated in sales and marketing activities (*e.g.*, joint presentations at educational conventions, provision of brochures and leads to the distributor).
6. The distributor was prohibited from selling competitive products, was required to use "best efforts" to sell the manufacturer's products, and was permitted to sublicense the manufacturer's products.

<u>"Franchise Fee"</u>

The FTC Franchise Rule defines "franchise fee" as follows: "as a condition of obtaining or commencing operation of the franchise, the franchise makes a required payment or commits to make a required payment to the franchisor or its affiliate." The FTC Franchise Rule specifically exempts *de minimis* payments (less than $500), as follows: "The total of the required payments, or commitments to make a required payment, to the franchisor or an affiliate that are made any time from before to within six months after commencing operation of the franchisee's business is less than $500." Under the FTC Franchise Rule, the following required payments may constitute a "franchise fee":

1. Rental payments;
2. Payments for advertising assistance or promotional materials;
3. Required purchases of inventory or supplies from the manufacturer or a third party supplier;
4. Payments for training (but excluding costs of attendance); or deposits for security or escrow.

Under most state franchise disclosure and registration laws, the "franchise fee" element is defined by statute as any payment above a *de minimis* threshold (typically $500) required for the right to enter into the franchised business (excluding purchases of goods at *bona fide* wholesale prices and the purchase or lease of real property). Cases in which courts have found certain payments to represent an indirect franchise fee include the following:

1. The dealer was contractually obligated to "maintain an adequate supply of current sales and service publications" and, over the nine-year history of the relationship, had paid over $1,600 for such manuals.
2. A dealer was required to purchase video cassettes, films, floats, banners, posters, and brochures to promote the manufacturer's products.

Various California Commissioner's opinions have considered the following types of payments as constituting a "franchise fee":

1. "Performance guarantee or deposit";
2. "Deposit of money";
3. "An initial or set-up fee";
4. "Fee for advertising";
5. "Nonrefundable bookkeeping charge";
6. "A payment for training and school expenses";
7. "Royalty or percentage of gross receipts";
8. "Charges for sales kits, brochures, programs, forms, decals, shirts, displays and announcements";
9. "Rental or lease fee"; and
10. "Payment for services, such as consulting or management fees."

The "franchise fee" element, while part of the statutory definition under most state franchise disclosure and registration laws, is often ***not*** part of the statutory definition under many franchise "relationship" statutes. In other words, even though a manufacturer or other supplier may not be required to provide a disclosure document or FDD or register it's "franchise," state "relationship" statutes may still "trump" contractual provisions governing termination and renewal, amendments, and other rights reserved to the supplier.

<u>Avoiding Application of "Franchise" Law</u>

Obviously, if a distribution relationship is subject to the FTC Franchise Rule and state franchise disclosure and registration requirements, there is nothing "voluntary" about compliance. In some cases, however, it may be debatable whether a distribution relationship is in fact a "franchise." More than one supplier has made a business decision that the benefits of franchise law compliance are worth the costs. These benefits include the following:

1. Avoidance of uncertainty about whether franchise laws apply;
2. The ability to collect franchise fees upfront;
3. An increased ability to control the quality and uniformity of the goods and services associated with the supplier's trademark; and
4. The fact that the extensive disclosures and documentation that are required may also make it more difficult for the franchisee to claim reliance on oral promises or "fraud in the inducement" (although such claims are not uncommon in franchise litigation).

Alternatively, even if a relationship is otherwise a "franchise," it may qualify for one or more exclusions or exemptions. The FTC Franchise Disclosure Rule excludes, for example:
1. Employer-employee and partner relationships;
2. Bona fide "cooperative associations";
3. Evaluation, testing, or certification services; and
4. Single trademark license.

The FTC Franchise Disclosure Rule also recognizes exemptions for:
1. "Fractional franchise," defined as a relationship in which the franchisee "has been in the type of business represented by the franchise relationship for more than 2 years and the parties anticipated, or should have anticipated, at the time the agreement establishing the franchise relationship was reached, that the sales arising from the relationship would represent no more than 20 percent of the sales in dollar volume of the franchisee";
2. "Leased department," defined as "an arrangement whereby a retailer licenses or otherwise permits a seller to conduct business from the retailer's location where the seller purchases no goods, services, or commodities directly or indirectly from the retailer, a person the retailer requires the seller to do business with, or a retailer-affiliate if the retailer advises the seller to do business with the affiliate";
3. Petroleum Marketing Practices Act franchises; and
4. Oral agreements.

Last but not least, the FTC Franchise Disclosure Rule contains the following sophisticated investor examples:
1. "Large investments" in which at least one individual owner of the franchisee makes an initial investment of $1 million or more—excluding franchisor franchising or the cost of unimproved land—within the first three months of operations;
2. "Large franchisees," *i.e.*, sales to franchisee entities (not individuals) with at least five years of experience in any line of business and a $5 million net worth; and
3. "Franchisor insiders," *i.e.*, officers, directors, general partners, or individual with management responsibility that meet certain ownership tests.

An exemption or exclusion from the FTC Franchise Rule will ***not*** automatically provide an exemption or exclusion from state franchise disclosure, registration, and "relationship" laws. Qualifying for an exemption or exclusion at the state level will thus require a state-by-state review of statutory language. Examples of exemptions and exclusions available at the state level include:

1. Large franchisor, based on both experience and net worth (*e.g.*, New York and North Dakota);
2. Renewal of an existing franchise on the same material terms and conditions as the existing franchise (*e.g.*, Michigan);
3. Sale by a franchisee in which the buyer assumes the selling franchisee's existing franchise agreement (*e.g.*, Wisconsin);
4. Isolated sales (*e.g.*, Illinois, and Indiana Minnesota, New York);
5. Minimum or excluded payments, with the threshold varying by jurisdiction;
6. Fractional franchise (equivalent to the FTC Franchise Rule exemption); and
7. Sophisticated franchisee (prior experience or relationship with the franchisor; recognized in only a few jurisdictions).

It is also possible to structure the relationship to try to avoid application of the franchise laws. As the foregoing cases demonstrate, this may be easier said than done. A number of common contractual provisions that increase the risk of being deemed a "franchise" are desirable if not necessary provisions of most distribution agreements. Also, it may be difficult to obtain an opinion of counsel that a relationship is not a "franchise."

Avoiding the first definitional element of a "franchise," the trademark element, may not be possible where trademarked goods and services are involved.

Avoiding the second element, "assistance or control," may be inconsistent with trademark protection and with the supplier's desire to ensure proper distribution of goods and services under its trademarks. Under the federal trademark statute, the Lanham Act, the trademark owner has the right to control the quality and uniformity of goods and services furnished under its trademark.

Indeed, the trademark owner has an affirmative duty to do so. Failure to exercise such control may even constitute an abandonment of trademark rights. Only by imposing various requirements on independent distributors, and only by providing assistance such as training or promotional materials can suppliers ensure that end-users receive proper service and support. Contractual provisions intended to protect trademarks and good will and to ensure customer satisfaction may therefore have unintended consequences as well. These contractual provisions may establish the "assistance or control," "marketing plan," or "community of interest" element of a franchise. Eliminating such terms from the contract—or providing no assistance such as training or promotional materials—is often not a viable option. Nor would such drastic steps necessarily guarantee that the "distributorship," "sales agency," or whatever it is called will not be held to be a "franchise" anyway.

Avoiding the third element, the "franchise fee," may be the easiest to accomplish. The types of payments that may constitute an indirect franchise fee are such that even this is difficult, however.

Also, foregoing such payments may not be a sound business decision. Finally, even without a franchisee fee, a relationship that is not subject to franchise disclosure and registration requirements may still be subject to franchise "relationship" laws of general applicability.

The worst way to try to avoid application of the franchise laws, however, may seem to be the most obvious way. That is to obtain from the prospective distributor a waiver of its rights under federal and state franchise laws. Typically, such a waiver will be unenforceable. Even worse, the attempted waiver may itself violate the franchise laws—subjecting the supplier to the various adverse consequences previously described. Even with this confusing and unclear regulatory framework, product distribution in the U.S. can obviously still be very lucrative. It simply requires guidance from counsel to avoid these pitfalls.

For further information about this topic or other US legal issues, please contact:

Michael J. Lockerby, Foley & Lardner LLP
+1 202-945-6079
mlockerby@foley.com

James P. Peterson, Foley & Lardner LLP
+1 414-297-5892
jpeterson@foley.com