What Makes a Franchise?

The Franchise Fee

By Howard Yale Lederman

Fast Facts:

Franchising is an ever-growing part of the American economy.

Under the Michigan Franchise Investment Law, to be a franchise, a contract must meet three requirements, including a franchisor requirement that the franchisee pay a direct or indirect franchise fee.

In *Hamade v Sunoco, Inc (R & M),* the Michigan Court of Appeals interpreted the franchise fee requirement and considered the indirect franchise fee alternative for the first time.

Franchising has exploded into "a giant engine of the American economy."[1] Franchising "account[s] for 50 percent of all retail sales and…$1 trillion in sales annually in the United States."[2] Franchising generates about "21 million jobs in the United States alone and yields $2.3 trillion in economic output."[3] The 21 million jobs represent approximately 14 percent of U.S. jobs.[4] The number of franchise establishments has mushroomed to "more than 900,000…."[5] The over $1 trillion represents about 10 percent of the U.S. private-sector economy.[6] In Michigan, the number of franchisors "has grown 27 percent in Michigan since 2003, with 1,350 now operating."[7] Thus, notwithstanding Michigan's severe recession, franchising is big business.

Although the word "franchise" arose from the idea of freedom from servitude, restraint, or burden,[8] franchisor domination and pre-contract fraud have been major problems. While providing some franchisees with large profits, franchising has also enabled "a large corporate franchisor to take unfair advantage of a small franchisee…."[9] The imbalance of power between franchisor and franchisee became huge, and abuses multiplied. For example, in California, "franchisees have suffered substantial losses where the franchisor or his representative has not provided…complete information regarding the franchisor-franchisee relationship, the details of the [franchise] contract," and the franchisor's "business experience."[10] The Commissioner of Corporations recognized "the need for legislation protecting individuals from the loss of their investments in franchises due to causes ranging from outright fraud to simple incompetence."[11] In response, the California legislature passed the nation's first franchise investment protection law, the California Franchise Investment Law. Its purposes are "to provide each prospective franchisee with the information necessary to make an intelligent decision" on whether to invest in a franchise, to bar sale of franchises when the sale would lead to fraud, and "to protect the franchisor[,] by providing [both parties with] a better understanding of the relationship."[12]

In further response, the Federal Trade Commission promulgated a rule, and 16 other states passed franchise investment laws similar to California's.[13] The FTC Rule requires franchisors to provide prospective franchisees with a disclosure document containing specific items of information about the offered franchise, its officers, and other franchisees.[14] These items include

the franchisor's litigation history, past and present franchisees' contact information, any exclusive territory accompanying the franchise, franchisor assistance, franchise purchasing and start-up costs, and franchisor financial performance representations.[15] On January 23, 2007, the FTC amended its rule to make it more like the state laws.[16]

In 1974, the Michigan legislature passed the Michigan Franchise Investment Law (MFIL).[17] The legislature mandated that MFIL "shall be broadly construed" to achieve its purpose.[18] MFIL's purpose was "to remedy perceived abuses by large franchisors engaged in manipulating, coercing or lying to unsophisticated investor franchisees."[19] The Wisconsin Supreme Court emphasized that a similar law's purpose was to protect dealers "who make a substantial investment in inventory, physical facilities or 'goodwill.'"[20] The idea was to protect franchisees' investments from franchisor termination without notice or good cause. Accordingly, MFIL required pre-termination notice, an opportunity to cure the alleged failure leading to termination, and good cause.[21] MFIL also severely restricted the franchisor's power to refuse to renew a franchise.[22]

However, for the FTC Rule or MFIL to apply, the franchisor-franchisee agreement must be a franchise. Thus, it must meet the FTC Rule's or MFIL's franchise definition. As under the FTC Rule and most other state franchise laws:[23]

> (3) "Franchise" means a contract or agreement, either express or implied, whether oral or written, between two or more persons to which all of the following apply:
>
> (a) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor.
>
> (b) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate.
>
> (c) The franchisee is required to pay, directly or indirectly, a franchise fee.[24]

The franchise fee requirements' purposes are to protect investing franchisees; "where there is no investment, there is no fear of inequality of bargaining power."[25] MFIL defines a franchise fee as "a fee or charge that a franchisee or subfranchisee is required to pay or agrees to pay for the right to enter into a business under a franchise agreement, including but not limited to payments for goods and services."[26] Under MFIL, payments for "goods, equipment, or fixtures…at a bona fide wholesale price" are not franchise fees.[27] The Michigan Administrative Code defines a bona fide wholesale price.[28] Other franchisor-required payments, if conditions for entering into or maintaining the franchise, are franchise fees.[29] As the franchise fee requirement is part of a remedial act, the courts should interpret the requirement to achieve the act's purposes liberally.[30]

Until mid-2006, Michigan appellate courts had not interpreted MFIL's franchise fee provision. Then, the Michigan Court of Appeals decided *Hamade v Sunoco, Inc (R & M)* and analyzed the franchise fee requirement for the first time.[31] In 1986, Hamade, with Sunoco's approval, bought a Sunoco gas station and until 1997, they signed and extended contracts. But Sunoco conditioned its signature on a new contract on Hamade's agreement to a mandatory monthly fuel sales increase from 42,000 gallons to 94,000 gallons and agreement to arrange and pay for larger fuel tanks, relocation of the fuel tank area, installation of a canopy, installation of larger service station islands and fuel dispensers, and remodeling of the service station store. These conditions arose from Sunoco's pressure on Hamade to sell more fuel.

Though costing him $400,000–$500,000, Hamade completed these mandates. After loaning Mr. Hamade $55,000 for part of these mandates, Sunoco conditioned any long-term contract on his agreement to repay this loan. Also, Sunoco loaned him equipment valued at $43,500. Sunoco amortized these loan and equipment charges over the subsequent 1997 contract period. The parties agreed on a 1997 contract incorporating these and other provisions described below. But in September 2000, Sunoco approved the opening of a new Sunoco station about a mile away from Hamade's station. To Hamade, this event and Sunoco's delivery of bad fuel caused his station to fail.

Hamade sued Sunoco for MFIL violations. When defendants moved for summary disposition, the lower court granted the motion, holding that MFIL did not apply, because Hamade had not paid a franchise fee. Affirming, the Court concluded that he had not met the franchise fee requirement. The Court ignored MFIL's and the franchise fee requirements' remedial legislative purposes. This opened the decision to legitimate criticism.

First, the Court concluded that Sunoco's compulsory monthly fuel sales quota increase from 42,000 gallons to 94,000 gallons did not impose an indirect franchise fee. The Court recognized that "[a]n obligation to carry a large inventory can be the economic equivalent of a franchise fee. An excessively large inventory transfers cash to the seller without producing benefits for the buyer; and the interest the seller earns by making the sales earlier is a kind of fee. Like a cash payment, it transfers wealth from buyer to seller."[32] However, the Court found that the sales price was a bona fide wholesale price, as Sunoco required Hamade "to purchase his monthly quota of fuel at the dealer tank wagon price (DTW) price in effect at the time and place of delivery."[33] Also, during the year before the signing of the 1997 agreement, Hamade "was selling a monthly average of fuel closer to the agreed-upon amount of 94,000 gallons a month."[34] Accordingly, the Court found that sales quota "reasonable in light of [his] sales history."[35] Thus, the Court did not find an indirect franchise fee. The Court's conclusion and reasoning on the inventory requirement and sales price issues were well-supported.

Next, the Court held that the 1997 agreement's $10,000 collateral deposit was not an indirect franchise fee. The agreement compelled Hamade to deposit that amount with Sunoco to pay any past, present, or future debts. Sunoco had to pay interest on the deposit and return it to Hamade at the end of the agreement. But "a transfer of wealth from the franchisee to the franchisor" was absent.[36] Since Hamade had "retained ownership of the deposited funds and was not deprived of the time value of the

funds [due to earned interest], there was no transfer of wealth to Sunoco" and no indirect franchise fee.[37]

The Court's analysis had a serious drawback. The Court overlooked the fact that the compulsory deposit was a precondition of Sunoco's agreement to contract with Hamade. This precondition overrode the requirements for Sunoco to pay interest on the deposited funds and return them. *Despite the interest and return requirements, the compulsory deposit remained a contract precondition*. Accordingly, the Court's reasoning here was incorrect.

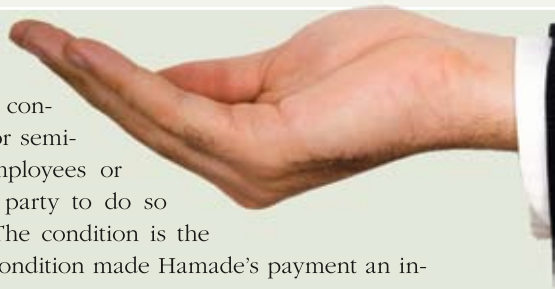
The Court further held that Sunoco's compulsory service station rehabilitation costing Hamade $400,000–$500,000 did not constitute an indirect franchise fee. First, the Court emphasized that Hamade had paid a contractor, not Sunoco, to rehabilitate the station. Second, the Court cited the $43,500 equipment loan. Third, the Court characterized the $55,000 loan "to pay for the installation of the loaned equipment" as a gift.[38] Fourth, the Court cited "the remodeling of the garage bays into a convenience store, whose profits benefited only Hamade."[39] While recognizing that "Sunoco indirectly benefited from the improvements" because of their potential contribution to increased fuel sales, the Court found that any such increase "also benefited Hamade."[40] Concluding that "the improvements primarily benefited Hamade(,) rather than Sunoco," the Court did not find an indirect franchise fee.[41]

The Court's reasoning on payment to a contractor, though representing predominant case law, is unconvincing. The Court cited *Implement Service,* which involved a dealer's free warranty work on small engines. The Court held that this performance did not constitute a franchise fee, as the dealer performed the work for customers, not the manufacturer. The dealer also conducted training schools for others and distributed advertising displays. The Court concluded that these services involved no indirect franchise fees, as they were ordinary business endeavors leading to ordinary business expenses, and the dealer performed them for others. *Implement Service* cited *Premier Wine & Spirits of South Dakota, Inc v E & J Gallo Co,*[42] where the Court referred to the California Commissioner of Corporations' guidelines declaring that payments to third parties, even if required, are not franchisee fees.[43] But all three courts ignored the Commissioner's caveat: *"[I]f such payment is not made for the right to enter into business."*[44]

Sunoco conditioned Hamade's right to remain a Sunoco dealer on his remodeling of the station. Since Hamade was not a construction contractor, meeting Sunoco's condition compelled him to pay a third-party contractor to remodel his station. *Sunoco conditioned Hamade's ability to remain a Sunoco dealer on his remodeling of the station and that payment to the third-party contractor.* Therefore, Hamade's payment met the Commissioner's caveat, and Sunoco's remodeling condition made that payment an indirect franchise fee.

The Court's reasoning also contradicted the franchise acts' remedial legislative purpose and introduced unjustified franchise fee distinctions. If a franchisor compels a franchisee to pay a fee to attend training sessions as a condition of signing a franchise agreement, the condition to pay should be a franchise fee. *The key is not to whom the prospective franchisee pays the fee, but whether the fee's payment is a condition to enter the business.*

If a franchisor compels a franchisee to pay a fee to attend training sessions as a condition of signing a franchise agreement, the condition to pay should be a franchise fee.



Whether the franchisor conducts training classes or seminars with in-house employees or contracts with a third party to do so makes no difference. The condition is the same. Thus, Sunoco's condition made Hamade's payment an indirect franchise fee.

The second and third parts of *Hamade*'s reasoning regarding the service station rehabilitation likewise contradicted MFIL's remedial legislative purpose and were not persuasive. The $43,500 equipment loan charge and the $55,000 were indirect franchise fees, because Sunoco conditioned its approval of the 1997 agreement on Mr. Hamade's agreement to repay these amounts. The repayment requirements negated the Court's finding that the $43,500 and $55,000 loans were gifts. Both amounts were loans. The Court's reasoning that Hamade's purchase of every required gallon of fuel changed the $55,000 amount from a loan into a gift overlooked the fact that repayment of the loan remained compulsory. Mandatory repayment of a gift is self-contradictory. Amortization through fuel purchases was only the repayment means. It did not change the requirement or repayment facts. Neither MFIL nor the regulation mandated any particular form of repayment for a charge to be a franchise fee. As a result, both amounts were indirect franchise fees.

The remaining parts of the Court's reasoning regarding the service station remodeling were unconvincing. Rather than interpreting the remedial act's franchise fee provision liberally, the Court introduced yet another inquiry: Who benefits most? In deciding a motion for summary disposition, the Court improperly decided who benefited most from the station rehabilitation. The convenience store benefited Hamade and Sunoco. Thus, the Court's focus on benefits was beside the point. *The remodeling condition was the point.* If he wanted to contract with Sunoco, Hamade had to remodel the garage into a convenience store and pay $400,000–$500,000 to do so. He had to repay the $55,000 and $43,500 loans to do so. Since these payments were Sunoco contracting preconditions, they were indirect franchise fees.

Therefore, the Court held that Hamade did not meet the MFIL franchise fee requirement, that he did not have a franchise, and that MFIL did not apply. *Hamade* was the Court's first case interpreting MFIL's franchise fee requirement. The decision did not cover all possible indirect franchise fee issues. Its reasoning is challengeable. Using non-Michigan franchise fee decisions remains essential. But *Hamade* is Michigan's starting point. ■

Howard Yale Lederman is an officer and Publications Committee co-chairperson of the State Bar of Michigan Antitrust, Franchising & Trade Regulation Section. He is also a charter member of the State Bar Appellate Practice Section. He practices mainly appellate, commercial, and employment litigation with Norman Yatooma & Associates, PC, in Birmingham, Michigan. Several Michigan publications have published his appellate, commercial, and employment law articles and updates.

FOOTNOTES

1. Dunham, *Federal franchise legislation and Congress's own duty of competence and due care,* 21 Franchise L J (Fall 2001), available at <http://www.wiggin.com/pubs/articles_abstract.asp?ID=14485011282001>, citing and quoting the GAO Report and International Franchise Association Estimates (accessed August 18, 2008). All websites in this article were accessed August 18, 2008.
2. U.S. General Accounting Office, *Federal Trade Commission Enforcement of the Franchise Rule,* GAO-01-776 (July 2001), p 5 <http://www.gao.gov/new.items/d01776.pdf>.
3. International Franchise Association, *Welcome to IFA* <http://www.franchise.org/> [updated from 2003 to a recent PricewaterhouseCooper study].
4. Flemming, *Ready-Made Business,* Lake Winnebago Business to Business (September 2006), citing 2003 PricewaterhouseCooper study, available at <http://www.winnebagob2b.com/sept06franch.html>.
5. International Franchise Association, *supra* [updated from 2003 to a recent PricewaterhouseCooper study].
6. Flemming, *supra,* citing 2003 PricewaterhouseCooper study.
7. Guest, *Betting it all on a franchise,* Detroit Free Press, December 10, 2006, pp 1A, 32A, available at <http://www.thefranchisemall.com/news/articles/17505-0.htm>.
8. *Webster's Third New International Dictionary* (Merriam Webster, 1993), p 902; Bizymoms Franchises, *The Origins of Franchising* <http://www.bizymoms.com/franchises/articles/origins.html>.
9. Steinberg & Lescatre, *Beguiling heresy: Regulating the franchise relationship,* 109 Penn St L R 105, 116 (2004), quoting *Piantes v Pepperidge Farm, Inc,* 875 F Supp 929, 938 (D Mass, 1995).
10. *Gentis v Safeguard Business Systems, Inc,* 60 Cal App 4th 1294, 1299; 71 Cal Rprt 2d 122 (1998).
11. *Id.,* citing Pierno, *Franchise regulation—The need for a new approach,* L A Bar Bulletin (September 1969), pp 501 *et seq.*
12. *Id.;* Accord, *To-Am Equipment Co, Inc, v Mitsubishi Caterpillar Forklift America, Inc,* 152 F3d 658, 662 (citing Illinois Franchise Disclosure Act, 815 Ill Comp Stat 705/2(2)).
13. E.g., 16 CFR Sec 436.1 *et seq.*, Electronic Code of Federal Regulations (May 30, 2008) <http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=4502e8eef6>; California Franchise Investment Law, Cal Corp Code Sec 31005(a)(1–3); Connecticut Franchise Act, Conn Gen Stat Sec 42-133e(b); Indiana Deceptive Franchise Practices Act, Ind Code Ann Sec 23-2-2.5-1(i–iii); Illinois Franchise Disclosure Act, 815 Ill Comp Stat 705/3(1)(a–c); North Dakota Franchise Investment Law, N Dak Cent Code Sec 51-19-02 (5)(a)(1–3); Virginia Retail Franchising Act, Va Code Sec 13.1-559(A)(1–3); Rhode Island Franchise Investment Act, R I Gen Laws Sec 19-28.1-3 (7)(1)(A); Washington Franchise Investment Protection Act, Wash Rev Code Sec 19.100.010(4)(a)(i–iii); Wisconsin Franchise Investment Law, Wis Ann Statutes Sec 553.03(4)(a)1–3.
14. Federal Trade Commission, *FTC Issues Updated Franchise Rule* (January 23, 2007) <http://www.ftc.gov/opa/2007/01/franchiserule.shtm>. Accord, 16 CFR Sec 436.2-4.
15. Federal Trade Commission, *FTC Issues Updated Franchise Rule, supra.* Accord, 16 CFR Sec 436.5. See companion article in this issue of the *Bar Journal* on page 28.
16. Federal Trade Commission, *FTC Issues Updated Franchise Rule, supra.* Accord, 16 CFR Sec 436.1 *et seq.*
17. MCL 446.1501 *et seq.*
18. MCL 446.1501.
19. *Jerome-Duncan, Inc v Auto-By-Tel, LLC,* 989 F Supp 838, 842 (ED Mich, 1997), citing Michigan House Legislative Analysis, HB 4203, August 2, 1974. Accord, *Geib v Amoco Oil Co,* 29 F3d 1050, 1056 (CA 6, 1994).
20. *Moodie v School Book Fairs, Inc,* 889 F2d 739, 742 (CA 7, 1989), quoting *Foerster, Inc v Atlas Metal Parts Co,* 105 Wis 2d 17, 24; 313 NW2d 60 (1981). Accord, *Ziegler Co v Rexnord, Inc,* 139 Wis 2d 593, 605; 407 NW2d 873 (1987), *Kubis & Perszyk Associates, Inc v Sun Microsystems, Inc,* 146 NJ 176, 182–184; 680 A2d 618 (1996), *Westfield Centre Service, Inc v Cities Service Oil Co,* 86 NJ 453, 461–462; 432 A2d 48 (1981).
21. MCL 445.1527(c).
22. MCL 445.1527(d), (e).
23. E.g., California Franchise Investment Law, Cal Corp Code Sec 31005(a)(1–3); Connecticut Franchise Act, Conn Gen Stat Sec 42-133e(b); Indiana Deceptive Franchise Practices Act, Ind Code Ann Sec 23-2-2.5-1(i–iii); Illinois Franchise Disclosure Act, Ill Comp Stat 705/3(1)(a–c); North Dakota Franchise Investment Law, N Dak Cent Code Sec 51-19-02 (5)(a)(1–3); Virginia Retail Franchising Act, Va Code Sec 13.1-559(A)(1–3); Rhode Island Franchise Investment Act, R I Gen Laws Sec 19-28.1-3 (7)(1)(A); Washington Franchise Investment Protection Act, Wash Rev Code Sec 19.100.010(4)(a)(i–iii); Wisconsin Franchise Investment Law, Wis Ann Statutes Sec 553.03(4)(a)1–3.
24. MCL 445.1502(3) (emphasis added).
25. *Wright-Moore Corp v Ricoh Corp,* 794 F Supp 844, 850 (ND Ind, 1991) (on remand). Accord, *Wright-Moore v Ricoh Corp,* 908 F2d 128, 136 (CA 7, 1990); *Kenosha Liquor Co v Heublein, Inc,* 895 F2d 418, 419 (CA 7, 1990); *Forester, Inc v Atlas Metal Co,* 105 Wis 2d 17, 24; 313 NW2d 60 (1981); *Moodie,* 889 F2d 739, 742; *Moore v Tandy Corp,* 819 F2d 820, 822–823 (CA 7, 1987); *Thueson v U-Haul Int'l, Inc,* 144 Cal App 4th 664, 675; 50 Cal Rptr 3d 669 (2006), modif 2006 Cal App Lexis 1833 (2006), *Gentis,* 60 Cal App 4th 1294, 1298–1299; *Getty Petroleum Marketing, Inc v Ahmad,* 253 Conn 806, 819; 757 A2d 494 (2000); *Hartford Electrical Supply Co v Allen Bradley Co,* 250 Conn 334, 345; 730 A2d 824 (1999); *Kubis & Perszyk Assoc, Inc v Sun Microsystems, Inc,* 146 NJ 176, 182–184; 680 A2d 618 (1996).
26. MCL 445.1503(1) (emphasis added).
27. MCL 445.1503(1)(a).
28. Mich Admin Code R 445.101(2).
29. *Id.*
30. *US Mac Corp v Amoco Oil Co, CCH Franchise Guide 11,* 963 (Cal App, 2000), *Kim v Servosnax, Inc,* 10 Cal App 4th 1346, 1356; 13 Cal Rptr 2d 442 (1992).
31. *Hamade v Sunoco, Inc (R & M),* 271 Mich App 145; 721 NW2d 233 (2006), lv den 477 Mich 912; 722 NW2d 808 (2006).
32. *Id.* at 156, quoting *Digital Equipment Corp v Uniq Digital Technologies, Inc,* 73 F3d 756, 760 (CA 7, 1996).
33. *Id.* at 157.
34. *Id.* at 158.
35. *Id.*
36. *Id.* at 160, citing *Implement Service, Inc v Tecumseh Products Co,* 726 F Supp 1171, 1179 (SD Ind, 1989) (interpreting Indiana Deceptive Franchise Practices Act).
37. *Id.* at 160.
38. *Id.* at 161.
39. *Id.*
40. *Id.* at 162.
41. *Id.*
42. *Premier Wine & Spirits of South Dakota, Inc v E & J Gallo Co,* 644 F Supp 1431 (ED Cal, 1986).
43. *Id.* at 1438–1439, citing California Commissioner of Corporations, *Guidelines for Determining Whether an Agreement Constitutes a 'Franchise,'* CCH Business Franchise Guide, para 7558 at 12,353.
44. *Id.* at 1439, quoting *Guidelines, supra,* para 7558 at 12,353 (emphasis added).