STAR ATHLETES HAVE THEIR SIGHTS SET ON FRANCHISING

Beware: Franchise Sales Are Regulated Transactions

By Mark J. Burzych

Fast Facts:

Many professional athletes are investigating franchising as professional careers beyond sports.

Franchise sales are transactions regulated by the Federal Trade Commission and various states.

Franchisors must provide a franchise disclosure document to prospective franchisees before the sale of a franchise.

The 52nd Annual Convention of the International Franchise Association (IFA) held in February 2012 highlighted the formalized platform to help professional athletes become franchisees. The IFA and the Professional Athlete Franchise Initiative (PAFI) announced a memorandum of understanding to provide a centralized platform for athletes seeking to get involved in the franchise industry. The IFA-PAFI partnership will develop a program to provide athletes with training and education related to owning a franchise.

At the IFA convention, Tim Biakabutuka, Tyoka Jackson, and Jamal Mashburn addressed the topic of "Former Athletes Turned Franchise Owners." Representatives from franchise trade names such as Dunkin' Brands spoke about their programs that have successfully recruited former athletes as franchisees. A panel that included Sam Vincent, former Michigan State University standout and NBA veteran now with the National Basketball Retired Players Association, discussed the momentum created by the IFA-PAFI union. The IFA's focus on former athletes as potential franchisees at its annual convention highlights the available opportunities.

Scores of professional athletes are already involved in the franchise industry including Drew Brees (NFL), Jimmy John's; Leonard Davis (NFL), Smash Burger; Roosevelt Colvin (NFL), The UPS Store; Angelo Crowell (NFL), Jersey Mike's; Jamal Mashburn (NBA), Papa John's and Outback Steakhouse; Tim Biakabutuka (NFL), Bojangles; Junior Bridgeman (NBA), Wendy's and Chili's; Drew Gooden (MLB), Willie McGinest (NFL), and Ron Stone (NFL), WingStop; Tyoka Jackson (NFL), IHOP; Shaquille O'Neal (NBA), Auntie Anne's; George Tinsley (ABA-NBA), KFC, TGI Friday's, Burger King, and Pizza Hut; Nate Wayne (NFL), Cold Stone Creamery; Dewayne White (NFL), Dunkin' Donuts; Gerris Wilkerson (NFL) and James Butler (NFL), Golden Corral; Venus Williams (WTA), Jamba Juice; and Reggie Bush (NFL), Dennis Northcutt (NFL), Cory Ivy (NFL), and Keyshawn Johnson (NFL), Panera Bread.[1]

As more athletes explore their professional lives beyond sports and the franchise industry increases its focus on athletes as fertile franchisee candidates, franchisors must continue to adhere to the regulations governing the offering and sale of franchises and prospective franchisees must be aware of the legal protections offered by state and federal law and regulations related to the sale of franchises.

What is a Franchise?

Generally, a franchise is a business relationship in which the franchisee operates the franchisor's business system using the franchisee's own capital. Under the franchise rule of the Federal Trade Commission (FTC),[2] a "franchise" is any ongoing relationship in which a franchisor offers, sells, or distributes goods or services to third parties where:

- the goods or services being sold by the franchisee are identified by the franchisor's trademark;
- the franchisor will exert or has the authority to exert a significant degree of control over the franchisee's operation; and
- the franchisee pays the franchisor a fee.[3]

If the business transaction fits the definition of a franchise, it will be regulated by the FTC's franchise rule and, potentially, various state regulatory schemes, regardless of the title of the agreement.

Why Are the Sales of Franchises Regulated?

When the FTC put into effect the original franchise rule in the late 1970s, it found "widespread evidence of deception in the sale of franchises and business opportunities through both material misrepresentations and non disclosures of material facts."[4] Among other things, the FTC found that franchisors often made material misrepresentations about the seller, the costs of operating a franchise, the costs to purchase a franchise, the seller's financial viability, the earnings that a franchisee could generate, and the like.[5]

In an attempt to prevent these deceptive and unfair practices in the sale of franchises, the FTC adopted the original franchise rule, which was primarily a presale disclosure rule. Since the FTC believed that a more informed investor could determine whether investing in a franchise was the right decision, the franchise rule requires franchisors to disclose material information to prospective franchisees.

But the FTC's original franchise rule was seen by some states as being too little, too late. California and a few other states entered the franchise regulation arena in the early 1970s by passing statutes and regulations controlling the offer and sale of franchises and business opportunities within their states. Although the FTC promulgated its franchise rule, the rule did not take hold, as the North American Securities Administrators Association took the lead with its NASAA franchise disclosure guidelines. For more than 20 years, franchise regulation centered on the NASAA Uniform Franchise Offering Circular guidelines (UFOC).[6] The UFOC guidelines required franchisors to disclose specific information in a standard format organized in 23 items.

In the late 1990s, in an attempt to streamline the regulation of franchise sales, the FTC began the rule promulgation process to amend its franchise rule. On July 1, 2007, after nearly a decade of discussion, the FTC put into effect a new franchise rule to preempt the UFOC guidelines.[7] The new rule is modeled after the UFOC guidelines in format and content and requires franchisors to produce a franchise disclosure document (FDD) to disclose specific information in a standard format, similar to the UFOC guidelines' 23 items, before offering or selling a franchise. Since the FTC's franchise rule does not preempt state law, the stricter laws of several states must always be addressed by franchisors intending to operate in those states. For example, numerous states require franchise disclosure documents to be registered with state authorities.[8] In addition to the FTC's franchise rule and various state franchise disclosure statutes, practitioners must also consider a variety of state statutes that regulate the franchise relationship[9] and industry-specific statutes and regulations maintained by both federal and state governments in particular businesses such as petroleum and automobile dealers.[10]

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The Disclosure Required by the FTC Franchise Rule

If a proposed business structure meets the three elements of a franchise previously mentioned (trademark, franchisor's business system, and a fee), then it is a franchise, regardless of what the client wants to call it. And once a business relationship is determined to be regulated by the FTC's franchise rule, detailed disclosures to prospective franchisees are required before selling a franchise. Generally, the FDD should disclose the information prospective franchisees would want to know before they buy a franchise.

Specifically, the FTC's franchise rule requires franchisors to disclose:

- the identity of the franchisor and the business experience of the officers, directors, and other franchisor staff who will have contact with the franchisees (items 1 and 2);[11]
- litigation the franchisor has been involved with and whether the franchisor or any of its officers, directors, or key staff have filed bankruptcy petitions (items 3 and 4);[12]
- the initial franchise fee and other fees that must be paid to the franchisor (items 5 and 6);[13]
- an estimate of how much it will cost the prospective franchisees to open a franchise outlet and operate it for a period until the franchise outlet breaks even (item 7);[14]

- the restrictions regarding the sources of products or services to be offered by the franchise location, e.g., whether franchisees must purchase all supplies from the franchisor (item 8);[15]
- the franchisor's expectations of franchisees and what franchisees can expect from the franchisor (items 9 and 11);[16]
- whether the franchisor offers financing to its franchisees (item 10);[17]
- how the franchisor awards territories, if any, to the franchisees (item 12);[18]
- a list of trademarks the franchisees are expected to use in conjunction with operating the franchisor's system (item 13);[19]
- a list of patents, copyrights, and other proprietary information that will be licensed to the franchisees to operate the franchisor's system (item 14);[20]
- whether the franchisor expects the franchisees to participate in the actual operation of the franchise business (item 15);[21]
- restrictions on what the franchisees may sell (item 16);[22]
- a summary of the franchise agreement terms regarding renewal, termination, transfer, and dispute resolution (item 17);[23]
- the identities of any public figures used by the franchisor in conjunction with the sales of franchises (item 18);[24]
- the franchisor's estimate of the franchisees' financial performance (item 19);[25]
- the identity of each franchisee in the system and franchisees who have left the system (item 20);[26]
- the franchisor's audited financial statements with a comparison of year to year for the previous three fiscal years (item 21);[27] and
- a list (and form copies) of all documents and agreements that franchisees will be expected to sign (item 22).[28]

Compliance with State Laws

In addition to complying with the FTC's franchise rule, franchisors may need to comply with additional state regulations. Currently, 12 states require annual presale registration of a franchisor's FDD: California,[29] Hawaii,[30] Illinois,[31] Maryland,[32] Minnesota,[33] New York,[34] North Dakota,[35] Rhode Island,[36] South Dakota,[37] Virginia,[38] Washington,[39] and Wisconsin.[40] In each of these states, regulators will review the franchisor's FDD and approve it before providing the franchisor with the authority to sell franchises in that state. Michigan[41] and Indiana[42] require the franchisor to file a notice of intent to sell franchises, and Michigan requires state-specific language in an addendum to the FDD (although the actual addendum need not be filed or registered). In addition to these states' franchise laws, it is necessary to register or file exemption notices under the business opportunity laws of Florida,[43] Kentucky,[44] Nebraska,[45] Texas,[46] and Utah.[47]

In Michigan, a franchisor must produce an FTC franchise-rule-compliant FDD that also complies with the Michigan Franchise Investment Law. If any of the following provisions are in the franchise documents disclosed in the FDD, the provisions (not the entire FDD) are void and cannot be enforced against the franchisee:

- A prohibition of the franchisee's right to join an association of franchisees[48]
- A requirement that the franchisee assents to a release of the rights and protections provided in the Michigan Franchise Investment Law[49]
- A provision that permits the franchisor to terminate a franchise before the expiration of the specified term except for good cause, which includes the franchisee's failure to comply with any lawful provision of the franchise agreement and correct the failure after receiving written notice of the failure and a reasonable opportunity to correct it, which need not exceed 30 days[50]

- A provision that permits the franchisor to refuse to renew a franchise without fairly compensating the franchisee by repurchase or other means for the fair market value at the time of expiration of the inventory, supplies, equipment, fixtures, and furnishings[51]

- A provision that permits the franchisor to refuse to renew a franchise on terms generally available to other franchisees of the same class or type under similar circumstances[52]

- A provision requiring that litigation be conducted outside this state[53]

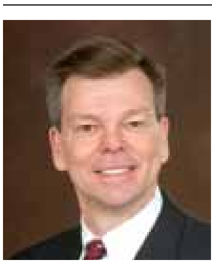
- A provision that allows the franchisor to refuse to permit a transfer of ownership of a franchise except for good cause[54]

- A provision that requires the franchisee to resell to the franchisor items that are not uniquely identified with the franchisor[55]

- A provision that permits the franchisor to directly or indirectly convey, assign, or otherwise transfer a franchisor's responsibilities to fulfill contractual obligations to a franchisee unless a provision has been made for providing the required contractual services[56]

Conclusion: Franchise Sales Are Regulated Transactions

In summary, the sale of a franchise is a regulated transaction that requires particular attention be paid to the applicability of the FTC's franchise rule; various states' franchise registration statutes, business opportunity statutes and regulations, and franchise relationship laws; and industry-specific statutes and regulations. Franchising is a complicated business requiring lawyers to know and understand the interplay between myriad regulations. High-profile athlete-franchisees have the capability to garner media attention for their performances on and off the field, which can be lucrative for the franchise system. Nonetheless, franchisors and counsel must be meticulous in their regulatory compliance, especially as the IFA-PAFI relationship brings more high-profile—perhaps unconventional—franchisees into franchise systems. ■



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FOOTNOTES

1. Brewer, *IFA steps up its game to enable professional athletes to become franchisees,* Franchising World, December 2010, available at <http://www.franchise.org/IFA_NEWS/IFA_Steps_Up_its_Game_to_Enable_Professional_Athletes_to_Become_Franchisees/> (accessed August 9, 2012).
2. 16 CFR § 436.1 *et seq.*
3. 16 CFR § 436.1(h).
4. 43 Fed Reg 59625.
5. 43 Fed Reg 59627-39.
6. The UFOC Guidelines were adopted by NASAA on April 25, 1993. Bus Fran Guide (CCH) ¶ 5900–5932. The FTC permitted franchisors to comply with the original rule by using the UFOC Guidelines format, provided they did so completely and accurately. See 60 Fed Reg 51895-01 (authorizing states to use revised UFOC Guidelines).
7. See 16 CFR § 436.1 *et seq.*
8. E.g., California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, North Dakota, New York, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Other states require the registration or exemption filings under their respective business opportunity statutes.
9. Statutes exist in Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, Virginia, Washington, and Wisconsin. Puerto Rico and the U.S. Virgin Islands have relationship laws.
10. For example, auto dealers are franchises of their respective automotive manufacturers and are protected by the Automobile Dealers' Franchise Act, commonly known as the Auto Dealers' Day in Court Act. 15 USC 1221 through 1225. Similarly, petroleum dealers are protected by the Petroleum Marketing Practices Act. 15 USC 2801 through 2806.
11. 16 CFR § 436.5(a) and (b).
12. 16 CFR § 436.5(c) and (d).
13. 16 CFR § 436.5(e) and (f).
14. 16 CFR § 436.5(g).
15. 16 CFR § 436.5(h).
16. 16 CFR § 436.5(i) and (k).
17. 16 CFR § 436.5(j).
18. 16 CFR § 436.5(l).
19. 16 CFR § 436.5(m).
20. 16 CFR § 436.5(n).
21. 16 CFR § 436.5(o).
22. 16 CFR § 436.5(p).
23. 16 CFR § 436.5(q).
24. 16 CFR § 436.5(r).
25. 16 CFR § 436.5(s).
26. 16 CFR § 436.5(t).
27. 16 CFR § 436.5(u).
28. 16 CFR § 436.5(v).
29. Cal Bus & Prof Code 20000 *et seq.*; Cal Corp Code 31000 *et seq.*
30. Hawaii Rev Stat 482E-1 *et seq.*
31. 815 Ill Comp Stat 705 *et seq.*
32. Md Code Ann, Bus Reg, 14-201 *et seq.*
33. Minn Stat 80C *et seq.*
34. NY Gen Bus Law 680 *et seq.*
35. ND Cent Code 51-19 *et seq.*
36. RI Gen Laws 19-28.1 *et seq.*
37. SD Codified Laws 37-5B *et seq.*
38. Va Code Ann 13.1-557 *et seq.*
39. Wash Rev Code 19.100 *et seq.*
40. Wis Stat 553.01 *et seq.*
41. MCL 445.1501 *et seq.*
42. Ind Code 23-2-2.5 *et seq.*
43. Fla Stat 559.802.
44. Ky Rev Stat Ann 367.801 *et seq.*
45. Neb Rev Stat 59-1722.
46. Tex Bus & Com Code 51.003(b)(8).
47. Utah Code Ann 13-15-4.5.
48. MCL 445.1527(a).
49. MCL 445.1527(b).
50. MCL 445.1527(c).
51. MCL 445.1527(d) (certain exceptions apply).
52. MCL 445.1527(e).
53. MCL 445.1527(f).
54. MCL 445.1527(g).
55. MCL 445.1527(h).
56. MCL 445.1527(i).