The Accidental Franchise

By David L. Steinberg and Moe Shrikian

Knowing the basic elements of a franchise under the Federal Trade Commission Rule[1] and the Michigan Franchise Investment Law (MFIL)[2] is critical to counseling your business client on what may first appear to be a simple licensing idea. A business plan presented by a client that satisfies federal or state law criteria necessary to establish the existence of a franchise will make the transaction a highly regulated activity. Licensing of a business concept that is in reality a franchise has been labeled as the "accidental franchise."

The FTC Rule regulates the sale of franchises. In addition, 17 states (including Michigan) have specific laws governing the offer and sale of franchises. These laws, while not intended to impact a "pure licensing agreement," regulate the offer and sale of licensing agreements that rise to the level of a franchise, requiring registration and provision of a detailed prospectus[3] before a franchise may be offered or sold. A violation of these statutes may subject the franchisor and its officers, directors, and executives to federal and state regulatory actions, civil liability, and, in some cases, criminal prosecution.[4] Although there is no federal registration requirement, the FTC Rule applies in all 50 states to the extent it is not preempted by more stringent state law requirements. The rule is a "disclosure rule" only, requiring the provision of a written franchise disclosure document. A prospective franchisee must be provided with the franchise disclosure document at least 14 calendar days before he or she pays any fees or signs an agreement. While the FTC may bring an action to cease and desist and issue fines and penalties, under federal law there is no civil private right of action to sue for violation of the FTC Rule. The opposite is true under the MFIL and the franchise laws or consumer protection laws of many other states.

Identifying the characteristics of a franchise will minimize the risk for your client. The name the parties give the agreement has been deemed immaterial by the courts; the existence of a franchise as defined by federal law or state statute cannot be disclaimed.[5]

Including in an agreement a provision stating that the parties recognize a franchise is not intended will not protect your client.

With this in mind, consider a common hypothetical situation. Bob has two Motor City Bagels stores offering 15 different types of bagels. The bagels are made on site from Bob's family recipes. He has created a unique logo to identify his stores, which he registered as a federal trademark. Customers have asked if he could teach them the business and allow them to use the Motor City Bagels name. Bob thinks this is a great way to open additional stores and expand the concept. He wants to charge a $50,000 fee to teach them the business plus a 5 percent royalty on gross sales. The licensee will be responsible for finding a suitable location with Bob's approval, signing a lease, and building and equipping the premises. The building's sign will read "Motor City Bagels." Bob will not require licensees to advertise; however, each licensee may advertise independently or join in co-marketing with Bob's stores. The licensee will use the name and logo in all advertising. Each store owner will be trained to make bagels using Bob's recipes. The licensee will be responsible for daily operations but must follow a manual created by Bob. Motor City Bagels will have the right to audit licensees' records to ensure they are properly paying royalties.

Is Bob's business plan a franchise that requires providing a disclosure prospectus and registration under the MFIL?

The FTC Rule

The Federal Trade Commission regulates the sale of franchises and business opportunities. The FTC Rule contains a broad definition of the term "franchise." Its definition encompasses both (1) the more familiar "business format" franchises, such as McDonald's, Baskin-Robbins, and 7-11, which involve the licensing of a trademark/service mark together with a prescribed marketing plan; and (2) arrangements commonly described as "business opportunities." For purposes of this article, a business opportunity also involves three characteristics that are not discussed in detail but must be part of any business plan analysis. The FTC Rule defines the business format franchise as involving the following three definitional elements:

(1) The franchisee sells goods or services associated with the franchisor's trademark, service mark, trade name, advertising, or other commercial symbol designating the franchisor, or must meet the franchisor's quality standards (use of trade name/trademark);

(2) The franchisor exercises significant control over, or gives the franchisee significant assistance in, the franchisee's method of operation (sale of a marketing plan); and

(3) The franchisee is required to make a payment of $500 or more to the franchisor or person affiliated with the franchisor at any time before or within six (6) months after the business opens (payment of franchise fee).[6]

FAST FACTS

The sale of franchises is regulated by the Federal Trade Commission and the Michigan Franchise Investment Law (MFIL), requiring delivery of a disclosure prospectus and registration.

The focus of the MFIL is whether a franchisee has been granted the right to sell goods or services under a marketing plan or system that is either prescribed in substantial part by the franchisor or substantially associated with its name or mark.

The federal rule focuses on the degree of "significant assistance" or "significant controls" placed on the franchisee's business operations by the franchisor.[7]

A determination as to whether control or assistance is significant is a factual matter. The FTC guidelines describe examples of significant types of control and assistance to include site selection or approval; site design; hours of operation; production techniques; accounting practices; personnel policies; promotional campaigns; restrictions on customers; locale or area of operation; sales, repair, or business training; accounting systems; management, marketing, or personal advice; system-wide networks and websites; and operations manuals.[8]

The Michigan Franchise Investment Law, MCL 445.1501 *et seq.*

Section 1502(3) of the MFIL defines a franchise as follows:

> "Franchise" means a contract or agreement, either express or implied, whether oral or written, between 2 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 of $500 or more.[9]

If all these criteria are met, the MFIL requires annual notice registration with the Michigan Department of Attorney General and provision of the franchise disclosure document. Failure to do so

subjects the franchisor to fines, penalties, stop orders, damages or rescission to the buyer, interest, attorney fees, and costs.[10]

Unlike the FTC definition, the MFIL focuses less on the criteria of significant assistance or imposition of significant controls and more on whether rights granted to a franchisee are to sell or market goods or services under a marketing plan or system that are *either* prescribed in substantial part by the franchisor *or* substantially associated with the franchisor or its affiliate's name, mark, or symbol.

The definition of a franchise under the MFIL is extremely broad, requiring case-by-case factual determination. While there has been little Michigan caselaw defining these criteria, counsel must be aware that they are interpreted broadly by the guidelines to the statute promulgated by the Michigan Department of Attorney General[11] on a public policy basis to protect the consumer-buyer. As a result, the statutory standard cannot be drafted out of a license agreement with assurance to the client that it will not be subjected to a future claim that it sold an unregistered franchise.

Is Motor City Bagels a franchise?

Each store is to be operated under the Motor City Bagels name and mark. Although advertising is not required, to the extent it occurs, the licensed name and logo will be used. To the public, the goods and services marketed and offered are associated with the Motor City Bagels name and trademarks. While Motor City Bagels manufactures its own products for resale, the statute *does not* distinguish between franchisors who are manufacturers and those who are not. Under the guidelines, a franchisee's business is "substantially associated" under 445.1502(3)(b) of the act with the franchisor's marks if the agreement or other circumstances permit or require the franchisee to identify its business to its customers primarily under its trade name or similar marks in a manner likely to convey to the public that it is an outlet of or represents directly or indirectly the franchisor.[12]

Since the value associated with most goods or services is tied to a brand name or mark, as a practical matter this requirement is met by most business concepts desiring to expand their market presence by a licensing arrangement. Most people would not be willing to pay a continuing royalty fee without having the benefit of a trademark or commercial symbol associated with a product or service. The marketing methods of Motor City Bagels satisfy this criteria of the statute. Because the initial payment and trademark/trade name criteria of the MFIL are easily met, the main issue often becomes whether there is sufficient factual evidence of a marketing plan prescribed in substantial part by the licensor. A determination that a program does not satisfy this criteria because a marketing program or system is not required and therefore there is no control over the operations of the licensee is factually based on objective evidence, including the control factors set forth by the federal guidelines.

Digital Message Systems was a company that developed a system for businesses to provide information to their customers while on hold during a phone call. The system was distributed through a network of dealers. In *Vaughn v Digital Message Systems Corporation*,[13] Digital Message Systems argued that there was no "marketing plan or system prescribed in substantial part," contending that the word "prescribe" meant "control" (which the company claimed did not exist). The court made clear that the MFIL contained no such requirement, and determined that "[p]rescribed in substantial part by the franchisor," should be interpreted in light of the following:

> A marketing plan may be determined to be prescribed if the franchise or other written or oral agreement, the nature of the franchise business, or *other circumstances permit or require the franchisee to follow an operating plan or standard operating procedure, or their substantial equivalent, promulgated by or for the franchisor. An operating plan or standard operating procedure includes required procedures, prohibitions against certain business practices, or recommended or offered practices, whether or not enforceable with economic sanctions.*[14]

The court further reasoned that the presence of four factors, among others, indicates that a marketing plan or system is prescribed in substantial part by the franchisor:

(1) The franchisee operates a business that can purchase a substantial portion of its goods solely from sources designated or approved by the franchisor;

(2) The franchisee must follow an operating plan, standard procedure, training manual, or its substantial equivalent promulgated by the franchisor in the operation of the franchise;

(3) The franchisee is limited as to type, quantity, or quality of any product or service the franchisee may sell; and

(4) The franchisor will aid or assist the franchisee in training or in obtaining locations or facilities for operation of the franchisee's business, or in marketing the franchisor's product or service.[15]

Proper analysis and development of a formal franchise program will assure that your client complies with federal and state regulations, eliminating the potential risks of fines, penalties, damages, rescission, interest, and attorney fees and costs.

This standard is met by the Motor City Bagels example. The company has a marketing plan that it substantially prescribes through training, operations manuals, forms or procedures, joint purchases, co-advertising, and recommended operating methods. Consider, however, whether the analysis would change if Motor City Bagels licensees did not advertise with Bob, did not purchase identical materials or products used by Bob but instead purchased from other sources, were not required to abide by any operating standard or procedures, or could sell or market any product or service related to their respective business without consent. Arguably, under these changed facts, a franchise relationship may not exist.

The third element of Section 445.1502(3) of the statute—payment of a direct or indirect franchise fee—is easily met. The fee element considers *all* sources of revenue paid to the licensor regardless of whether for products, services, or training as long as the payment is made for the right to associate with the licensor's name, mark, or commercial symbol. Motor City Bagels charges a $50,000 initial fee for the right to enter into the agreement plus a royalty of 5 percent on monthly gross sales. Either fee satisfies the fee payment element as it is not necessary for an upfront license fee to be paid. Further, even if an upfront fee or continuing royalty is not charged, a franchise fee may exist if goods or services are sold at prices in excess of bona fide wholesale prices or if payment of fees (e.g., training, marketing, site selection, or technology) is not optional but mandatory.[16]

If a client's proposed plan to market products or services through independent operators falls into the classification of a franchise, it is subject to federal and state regulations. Proper analysis and development of a formal franchise program will assure that your client complies with federal and state regulations, eliminating the potential risks of fines, penalties, damages, rescission, interest, and attorney fees and costs.[17] ■

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ENDNOTES

1. 16 CFR 436 *et seq.*
2. MCL 445.1501 *et seq.*
3. Commonly referred to as the "franchise disclosure document."
4. See, e.g., MCL 445.1534; MCL 445.1538; Cal Corp Code §§ 31300–31302; Cal Corp Code §§ 31410–31411.
5. See *SPX Corp v Shop Equip Specialists, Inc*, unpublished order of the U.S. District Court for the Western District of Michigan, entered July 16, 2001 (Docket No. 00-CV-00049).
6. See 16 CFR 436.1(h).
7. *FTC Interpretive Guidelines*, 44 Fed Reg 49966 (1979).
8. *Id.*
9. MCL 445.1502(3).
10. See MCL 445.1531.
11. Mich Admin Code, R 445.101 *et seq.*
12. Rule 445.101(5); see also *Jerome-Duncan, Inc*, 176 F3d 904, 911–912 (CA 6, 1999) (determining that since the dealership only garnered approximately 4 percent of its sales from its association with ABT and 96 percent of its sales from association with the Ford Motor trademark, "substantial association" did not exist).
13. *Vaughn v Digital Message Sys Corp*, unpublished opinion of the U.S. District Court for the Eastern District of Michigan, issued March 10, 1997 (Docket No. 69-CV-70533-DT).
14. *Id.* at *5.
15. *Id.* at *4–6.
16. See *Hamade v Sunoco, Inc*, 271 Mich App 145, 157–158 (2006).
17. See n 3, *supra.*