



Understanding The Fundamentals Of Franchise Law

By: Jim Heldman, Strauss Troy Co-Chair

I. REGULATION OF FRANCHISING

Franchising is regulated by the Federal Trade Commission Franchise Rule ("FTC Franchise Rule") and by various state agencies. A state's franchise laws usually apply only if the offer or sale of a franchise is made in the state; or the franchised business will be located in the state, or the franchisee is a resident of the state.

II. DEFINITION OF FRANCHISE UNDER THE FTC RULE

Under the FTC Franchise Rule, there are three elements of a franchise:

- A. Trademark. The franchisee is given the right to distribute goods and services that bear the franchisor's trademark, service mark, trade name, logo, or other commercial symbol.
- B. Significant Control or Assistance. The franchisor has significant control of or provides significant assistance to the franchisee's method of operation. Examples of significant control or assistance include:
 - i. approval of the site;
 - ii. requirements for site design or appearance;
 - iii. designated hours of operation;
 - iv. specified production techniques;
 - v. required accounting practices;
 - vi. required participation in promotional campaigns;
 - vii. training programs; and
 - viii. providing an operations manual.
- C. Required Payment. The franchisee is required to pay the franchisor (or an affiliate of the franchisor) at least \$540 either before (or within 6 months after) opening for business. Required payments include any payments the franchisee makes to the franchisor for the right to be a franchisee. These include franchise fees, royalties, training fees, and payments for services. Payments to the franchisor for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale or lease are not included.

If all three elements are present, then the relationship will be deemed a "franchise" for purposes of the FTC Franchise Rule.

III. FTC DISCLOSURE REQUIREMENT

The FTC Franchise Rule requires franchisors to provide each prospective franchisee with a disclosure document, which is sometimes called an offering circular, at a certain point early in the process of offering and selling a franchise.

Laws in several states also require franchisors to provide a similar disclosure document. Because the FTC format for disclosure does not satisfy all of the state-law requirements in certain states, most franchisors choose to use the Uniform Franchise Offering Circular ("UFOC") format which is acceptable in all of the registration states. The UFOC Guidelines are lengthy and contain detailed requirements for the preparation of a UFOC. The FTC Franchise Rule permits use of the UFOC format since that format "affords prospective franchisees...more extensive

disclosures”.

Under the FTC Franchise Rule, the franchisor must give the disclosure document to the prospect at least 14 calendar days before the prospect signs any agreement with the franchisor; and at least 14 calendar days before the prospect pays any money to the franchisor.

The franchisor also must attach a copy of the franchise agreement to the disclosure document.

IV. STATE FRANCHISE LAWS IN GENERAL

A. State Law Definitions of Franchises. In certain states, the three elements of the legal definition of a "franchise" are:

- i. Marketing Plan. The franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system substantially prescribed by the franchisor.
- ii. Association with Trademark. The operation of the franchisee's business is substantially associated with the franchisor's trademark, trade name, service mark, etc.
- iii. Required Fee. The franchisee is required to pay a fee, directly or indirectly.

In other states, the three elements of the legal definition of a "franchise" are:

- i. Trademark License. The franchisee is granted the right to engage in the business of offering, selling or distributing goods or services using the franchisor's trademark, trade name, service mark, etc.
- ii. Community of Interest. The franchisor and franchisee have a community of interest in the marketing of goods or services.
- iii. Required Fee. The franchisee is required to pay a fee, directly or indirectly.

B. Categories of Laws. There are three general categories of state laws regulating franchises: disclosure laws, registration laws, and relationship laws.

Disclosure laws regulate required pre-sale disclosures; prohibited franchise sales practices; and mandatory cooling-off period before franchise sales.

Registration laws require registration of the franchise; registration of franchise salespersons; and registration of franchise advertising.

Relationship laws govern certain aspects of the relationship between franchisor and franchisee, such as: grounds for terminating a franchise; notice and cure periods before termination; grounds for not renewing a franchise; and equal treatment of franchisees.

C. Violations. The most common types of violations of franchise laws are:

- i. Offering or selling an unregistered franchise;
- ii. Failing to provide a UFOC on time;
- iii. Failing to provide all required disclosures in the UFOC;
- iv. Making misrepresentations to franchisee prospects; and
- v. Improperly terminating or not renewing a franchise.

D. Penalties. Penalties for violating franchise laws can include fines, permanent bans on engaging in franchising, freezing of assets, money damages for victims, and even jail sentences. These penalties can be applied to the franchisor, and to its officers, directors, and managers who formulate, direct or control the franchisor's activities. The violation of state franchise laws is typically treated under the

statutes as either a fraudulent and deceptive trade practice, or a misdemeanor, or a felony. In some states, a franchisee who has been harmed by the franchisor's conduct can be awarded money damages (including punitive damages and attorney's fees), or cancellation of the franchise agreement and reimbursement of all fees paid to the franchisor.

V. STATE REGISTRATION LAWS

- A. Franchise Registration. Although the FTC Franchise Rule does not provide for any registration of a franchise with the Federal Trade Commission, various states require that franchises, business opportunities and seller-assisted marketing plans must be registered with the state before they can be sold in the state. The franchise registration states are: California; Hawaii; Illinois; Indiana; Maryland; Michigan; Minnesota; New York; North Dakota; Rhode Island; South Dakota; Virginia; Washington; and Wisconsin. In most of these states, registration involves a review of the UFOC by a franchise regulator to determine compliance with state requirements. Some states simply require a filing of the UFOC.
- B. Business Opportunity Registration or Exemption. There are a number of states, such as Ohio, that require registration of business opportunities and seller-assisted market plans. The statutory definitions of these types of business relationships are often broad enough to include franchises, but most of these states, including Ohio, provide an exemption for franchises that comply with the FTC Franchise Rule.
- C. Advertising Filing. Some states require that advertising for the sale of franchises be filed with the state before they are published. Those states also generally restrict the content of franchisors' advertisements. These restrictions usually prohibit characterizing the franchise as a safe investment, or implying that state registration of the franchise means that the state has approved of the franchise. A few other states have similar content restrictions, but do not require filing of the advertisements.
- D. Salesperson Registration. The franchise registration states and certain other states also generally require the franchisor to file certain information about each person who will sell franchises in the state. This information includes the salesperson's home address and phone number, business addresses and phone number, social security number, date of birth, employment history, and information about certain civil and criminal proceedings involving the person.

VI. STATE RELATIONSHIP LAWS

There is no federal law governing franchise relationships. There are several states (not Ohio) that regulate some aspect of the franchise relationship, including termination, restrictions on non-renewal, repurchase obligations, transfer restrictions and certain other restrictions.

VII. OHIO BUSINESS OPPORTUNITY LAW

Ohio does not have a specific franchise law. Instead, the state regulates "business opportunities."

- A. Business Opportunity Plan. Ohio's Business Opportunity Purchasers Protection Act (the "Ohio Act") (copy attached) defines a business opportunity. For a plan to be a business opportunity, the buyer must be required to make an initial payment greater than \$500 but less than \$100,000. Additionally, the goods or services must be supplied by the seller, by a third person authorized by the seller, or by an affiliated person.

Also, to qualify as a business plan, the seller must make any one of the following representations:

- i. The purchaser will be provided with retail outlets, accounts, or help establishing them.

- ii. The purchaser will be provided with locations (or help finding locations) for vending machines, rack displays, or similar equipment used for the distribution or sale of the goods or services.
 - iii. The purchase can earn a profit greater than the initial payment.
 - iv. There is a market for the goods or services.
 - v. There is a buy-back arrangement.
- B. Exemptions. The Ohio Act has fourteen exemptions. For example, the law does not apply to the relationship between an employer and employee, the sale of an ongoing business, or previous purchasers of similar business plans. For the list of complete exemptions, see O.R.C. 1334.12.
- C. Disclosures Required in a Business Opportunity Agreement. Sellers of business opportunity plans must provide a written disclosure document 10 business days before the buyer purchases the plan. Required disclosures include: history of the company; identity and background of company officials; bankruptcy history; initial fees required for the purchase; and a description of the purchaser's requirements. For additional required disclosures including specific language that may be required, see O.R.C. 1334.02.
- D. Prohibited Actions. Sellers may not make false statements or misrepresentations about earnings, profits, or sales. They also may not accept a down payment of more than 20% of the total price before the goods or services are delivered. For more prohibited actions, see O.R.C. 1334.03.
- E. Right to Cancel. The Ohio Act gives purchasers generally five business days to cancel the agreement. Under certain circumstances, cancellation may occur within twelve months of signing the agreement.
- F. Compliance With Federal Law. Under O.R.C. 1334.13, as to a seller who complies with the FTC Franchise Rule, most of the provisions of the Ohio Act do not apply.

About the author: James Heldman is co-chairman of Strauss Troy, and his practice focuses on corporate and business law, including financing, mergers and acquisitions, securities regulation, franchising, real estate development and commercial transactions. You may contact him at 513.629.9421 or jgheldman@strausstroy.com.

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