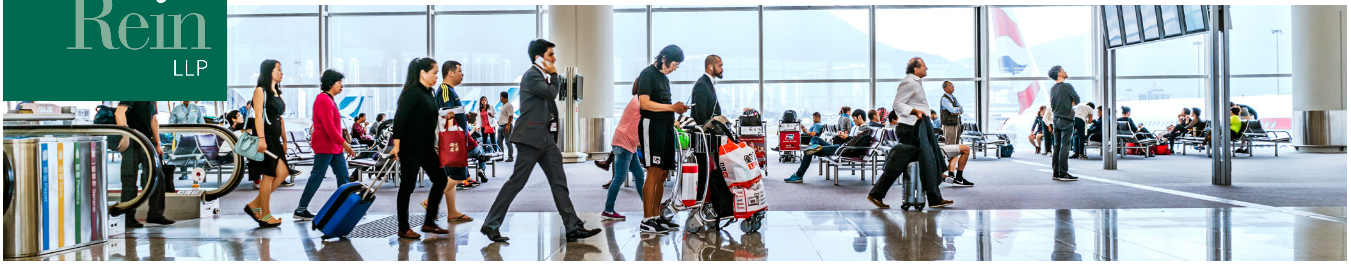
FRANCHISE *Law*



Legal Issues in Non-Traditional Development

What Is It?

A franchise is based on a uniform system of development and operation − uniformity of, among other things, product or service, design and layout and advertising. Non-traditional outlets deviate from that uniform system − usually with respect to location and/or format. Examples of non-traditional locations include airports, military bases, hospitals, casinos, schools, stadiums, arenas, and similar locations having a captive audience. Examples of non-traditional formats include kiosks or other satellite locations and food trucks.

Why Engage in Non-Traditional Development?

- **Sophisticated Franchisees.** Non-traditional franchisees are typically highly experienced multi-concept operators that have existing relationships with landlords or owners of host venues/facilities.
- **Mature Markets.** Non-traditional distribution provides an avenue for increasing system sales when markets for traditional outlets are at or near saturation.
- **Reduced Costs/Improved Margins.** Non-traditional outlets may offer lower operating costs and may be less susceptible to "value pricing" demands, allowing better margins.
- **Unserved or Unreachable Market Segments.** Non-traditional outlets may enable a franchisor to access a customer base that the franchisor might not otherwise be able to reach.
- **Speed.** Certain non-traditional outlets often can be opened for business more quickly than traditional outlets.
- **Brand Awareness.** Non-traditional outlets in high-visibility locations offer unique branding opportunities, leading to increased public awareness.
- **Captive Markets.** In addition to expanding the concept's typical consumer base, outlets in captive markets provide a potentially more predictable royalty stream than their traditional counterparts.

Drafting Considerations in Non-Traditional Development

Franchisors considering non-traditional development must first determine whether the territorial rights granted to existing franchisees permit this kind of development. Many franchisors expressly carve out non- traditional development from their territorial grants, and courts will generally respect such an express reservation by the franchisor. A few, mostly older cases, however, suggest that even if the existing franchisee does not have any exclusive territory, the implied covenant of good faith and fair dealing, which requires parties to an agreement to act honestly in their performance of the agreement and observe commercial reasonable standards, may restrict a franchisor's non-traditional development if the franchisor has not expressly reserved the right to expand its system. Even if contractually permitted to engage in non-traditional development, the franchisor must still evaluate whether the non-traditional outlet will cannibalize the sales of any existing outlets. Some franchisees may negotiate a right of first refusal with respect to non-traditional outlets, but few have the resources to compete with a more experienced non-traditional operator.

A franchisor also will need to evaluate and likely modify a number of the provisions in its traditional form of franchise agreement to address the unique features of non-traditional development and the demands of highly sophisticated operators, including:

- **Non-Competes.** As stated above, non-traditional franchisees often operate multiple concepts. Consequently, a franchisor's standard non-compete is typically a non-starter, and the parties will have to negotiate a much narrower restriction. In-term, the geographic scope of the non-compete is generally limited to the facility, excluding any existing conflicting businesses. Most non-traditional operators will not agree to a post-term non-compete.
- **Fees.** Depending on the bundle of rights granted, the non-traditional fee structure may vary from traditional fees. Generally, franchisors charge lower initial fees and advertising fees for non-traditional locations. In fact, some franchisors do not collect any advertising fees from non-traditional franchisees as non-traditional outlets do not receive the same benefits from advertising.
- **Term.** The term for a non-traditional outlet is generally shorter than a traditional outlet and is often tied to the expiration or earlier termination of the operator's contract to provide products or services at the facility.
- **System Modifications.** The non-traditional agreement must address the unique features of non-traditional development by permitting system adaptations in the areas of, among others, design and layout, products and services offered, operating hours, and required lease provisions.
- **Transfers and Termination.** In light of the substantial bargaining power that non-traditional operators wield, the scope of transfers requiring the franchisor's consent is typically quite narrow. In addition, the bases on which non-traditional agreements can be terminated are significantly scaled back, and, in many cases, the operators will seek to negotiate a right to terminate the agreement unilaterally.
- **Option to Purchase.** The option to purchase in non-traditional agreements is typically limited to equipment and inventory rather than all of the assets used in the operation of the outlet. Consequently, the franchisor will not have the right to take over the outlet's operation.
- **Guarantees.** Requiring a non-traditional operator to execute a guarantee is often a deal-breaker.

Is the Proposed Non-Traditional Outlet a Franchise?

A franchisor may not escape franchise registration and disclosure requirements simply by labeling a non-traditional franchise agreement a "license agreement." Even if a franchisor's traditional outlets meet the definition of a franchise, however, its non-traditional outlets will not necessarily qualify as franchises. Whether the relationship is a franchise depends on whether it meets the three elements of the legal definition of a franchise:

- Is a "franchise" fee charged? What constitutes a franchise fee is very broad and encompasses virtually all payments to the franchisor or its affiliates except for monies received for a reasonable quantity of inventory at a bona fide wholesale price.

- Is there a “substantial association” with the franchisor’s trademarks? Although the registration states and the Federal Trade Commission (FTC) differ on the degree of association required, the franchisor may be able to argue that there is insufficient association with its trademarks or commercial symbols where only a branded product is added to an existing business. Many courts have found that the threshold to satisfy this element is very low, however.
- Is there sufficient control or interdependence? There are three alternative tests used for this element. First, the FTC uses the “significant control” or “significant assistance” test, which is applicable in the majority of the states. This test focuses on the franchisor’s level of control or assistance over the franchisee’s entire business. Second, under the “marketing plan” test, which is used by several states, a franchise exists when the franchisor prescribes a marketing plan that the franchisee must follow. Third, under the “community of interest” test, which is used in a smaller number of states, a franchise exists when there is a sufficient level of interdependence between the franchisee and the franchisor.

Several types of relationships are excluded from franchise registration and/ or disclosure requirements, even though they technically are franchises. Some examples of the exclusions that may be available for non-traditional development include:

- **Fractional Franchises.** A fractional franchise generally is considered an addition to an existing business. To qualify as a fractional franchise, typically, the franchisee must have at least two years of experience in the same or a similar business, and the parties must reasonably expect that the franchisee’s sales from the franchised opportunity for the first year will not exceed 20% of the franchisee’s total sales. The FTC and California, Illinois, Indiana, Michigan, Minnesota, New York, Oregon, Rhode Island, South Dakota, Virginia, and Wisconsin include some form of fractional franchise exemption.
- **Sophisticated Franchisees.** A “sophisticated” franchisee generally must have a certain net worth or income, be required to invest a substantial amount of money in the franchise or have sufficient business experience. The FTC and California, Illinois, Rhode Island, South Dakota, and Washington exclude sales to “sophisticated” franchisees.
- **Existing Franchisees.** California, Hawaii, Maryland, Michigan, Minnesota, New York, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin exclude sales of additional franchises to existing franchisees.

Whether a non-traditional outlet will be considered a franchise must be determined on a case-by-case basis after a careful review of applicable federal and state law. As franchisors consider the decision, they also should consider the ultimate scope of their non-traditional development. If a franchisor intends to engage in non-traditional development on a nationwide basis, it may not be feasible to structure the relationship to avoid all applicable federal and state franchise registration/disclosure requirements. ■

FRANCHISE *Services*

Wiley Rein LLP represents franchisors on matters for which they require expert legal services. We can:

- Determine whether your business concept is a franchise. If it is a franchise, but you would prefer to avoid the registration disclosure requirements, we can help you to modify the business concept to avoid coverage by the franchise laws, if possible, or take advantage of applicable exclusions.
- Work with you to develop franchise and related agreements that will permit the growth of your concept while allowing you to maintain control.
- Seek federal registrations for your trademarks and provide assistance in maintaining and protecting those marks.
- Prepare the Franchise Disclosure Document (FDD) and provide FDD compliance training to your franchise sales and franchise administration teams.
- Prepare and file all franchise registrations, exemptions, amendments, and renewals in all applicable states.
- If you are a U.S. franchisor, assist you in developing your franchise concept abroad; if you are a foreign franchisor, assist you in bringing your franchise concept to the U.S.
- Help you understand your contractual rights and obligations and the statutory restrictions that apply to the franchise relationship, including transfers and contract renewals.
- Represent you in any proceedings brought by federal or state franchise regulators.
- Guide you in terminating the relationship with a franchisee without violating statutory restrictions.
- Represent you in litigation or arbitration proceedings with a franchisee.

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