ARE YOU AN INADVERTENT FRANCHISOR?

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Sales of goods and services from franchised operations were estimated to exceed $758 billion dollars and now represent over 35 percent of all retail sales in the United States according to Franchising in the Economy published by the International Franchise Association. In addition to its domestic penetration, U.S. franchisors are now represented in over 160 countries worldwide. Business Format Franchising, that portion of the "industry" represented by restaurants, food, personal and business services, and other retailers accounted for 232 billion in sales in the U.S. from over 408,000 locations. This was an increase in sales volume of 8.9 percent over 1990.

Prompted by this growth federal and state regulators have increased their attention to matters involving franchise sales compliance, the franchise relationship and interestingly, "the identification of inadvertent franchisors".

Inadvertent franchisors are those companies which have unknowingly chose to get their products and services to market through established distribution relationships that meet the requirements for a franchise under federal or state law. An "inadvertent franchisor" may include a dry cleaner who sells "turnkey" stores complete with equipment, training and a common trade name, and a joint venture between a manufacturer and retailer to distribute goods under a name.

The definition of a franchise is not uniform with variations between federal and individual state definitions; however there are common characteristics among these definitions. Generally, a franchise may be defined as:

1. The right to distribute goods and services using or which bear the franchisor's trademark, service mark, tradename, or other commercial symbols;

2. The exercise by the franchisor significant control over, or providing of significant assistance to the franchisee in connection with the franchisee's method of operation;

3. Payment of at least $500.00 or more to the franchisor within the first six months of operation.

Under the federal franchise disclosure rule if the three elements are satisfied a company may very well be considered a franchise and therefore be obligated to comply with the disclosure requirements of federal law.

In addition, business opportunity relationships are also subject to federal and state sales disclosure requirements. While business format franchises generally provide a system in addition to the license of the trade name and trade mark, such as Burger King, 7-Eleven and Blockbuster Video, business opportunities primarily involve the sale of a specific product or service which is not necessarily associated with a mark and has some type of buy-back or other arrangements promising an assured return. Examples would include Rack Jobbers, Vending Machine and other distributors where any payment is for the identified product sold.

While there is no federal registration of franchise offerings required, the federal disclosure rule requires the disclosure of specific information to prospective franchisees prior to any sale. The disclosure document specifies various information which must be included such as: business experience and background of the franchisor; litigation and bankruptcy history; initial and recurring fees; initial investment : and obligations of both the franchisor and the franchisee. Additionally, audited financial statements are required.   A franchisor is not required, but may choose to include earnings claims regarding the historic or prospective performance of units.

Currently, 15 states, representing 40 percent of all franchise investors, have enacted laws requiring registration and/or disclosure of information prior to the offer and sale of franchises and 24 states have business opportunity statutes.

Most states franchise sales laws are triggered by business activities within the state or the place at which the offer is made or acceptance of such offer occurs. Generally they apply when:

1. The offer is communicated to or from parties in the state; or

2. The offer is accepted by a party in the state; or

3. A prospective franchisee is domiciled in the state and plans to operate the franchise business in the state.

State laws differ on the definition of "offer" but generally it includes: every oral communication; written contact; promotional brochures, and advertising contained in newspapers, magazines, radio or television.

The requirements for obtaining registration of an offering vary from state to state thus regulatory modifications of the disclosure document are required for state specific purposes. Also states provide a franchisee with a private remedy for rescission, damages and other relief, if a franchisor inadvertently does not comply. The same is generally true under state business opportunity laws. However, franchisors and inadvertent franchisors may find exemptions under the state laws.
Thus, in the development of a broad based distribution system, it is essential that a company review its potential distribution relationships and consider the requirements which must be satisfied if the result is that the business constitutes a franchise or

business opportunity.

Inadvertency has increased in recent years because businesses either do not know the requirements or believe that they do not apply in their situation. Additionally, as the franchise and business opportunity laws have become more complex the regulatory agencies increase their focus in this area. Many companies may try to avoid the requirements of the federal and state rules and laws by modifying their distribution systems. Modification often weakens controls, negatively impacts the revenue stream, as well as may place the company in financial and legal jeopardy. Federal and state regulations may provide for civil and criminal penalties for inadvertency and intentionally avoiding franchise requirements.

Rather than establishing a distribution system geared to avoid franchise and business opportunity legal requirements, companies must first evaluate the best method they can utilize to suit their distribution, financial and other business needs.