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Welcome to MOHAJERIAN INC's monthly Newsletter. Each month we will provide our readers with pertinent industry, legal, and business information related to the Franchise industry. Your suggestions and interests are always valued; please forward all comments or suggestions to: info@mohajerian.com.

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The Advantages and Disadvantages of Franchising

Franchising has experienced dramatic growth because it offers significant advantages over other distribution methods. The first is the opportunity for rapid expansion. If a manufacturer, producer, or successful retailer sought to expand without franchising, the expansion would usually be extremely expensive in terms of actual outlays and management time.

Franchising requires far less capital than self-expansion and engenders far lower personnel costs. At least some part of the capital required for expansion through franchising will come from the initial franchise fees paid by the franchisees, who, unlike lenders, need not be repaid and, unlike investors, need not be offered stock or securities. Initial franchise fees will not cover the costs of expansion, but they will contribute substantially to the overall costs of undertaking a franchise program.

It is important to understand that even though the franchisees are making an "investment" in the franchise system, the franchise offering is not a security subject to registration under the securities laws. This is so because one element of the definition of a security is that the purchaser's profits will come from the efforts of others. Franchisee success does not come from the efforts of others. Whether the franchise purchaser manages the franchise and lets others do the day-to-day work, or the purchaser actively operates the franchise, he must expend enormous effort to make the franchise a success.

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However, the availability of expansion through franchising comes at a price. A company that does not franchise reaps all the profits of the expanded system; the business that franchises receives only initial fees and royalties on their franchisees' gross sales. Even though those royalties might be very substantial, it does not share in the franchisees' profits.

One warning is in order here. Suppose the franchise system is quite successful. The time may come when the franchisor will want to seek additional bank financing for further franchise expansion. Management might be surprised to find that its bank does not consider the flow of royalties from franchisees to be the sort of "asset" that constitutes adequate security. Even when a system has grown rapidly and its franchisees are extremely successful, some bankers refuse to grasp the real value of a franchise system for asset based lending. Many banks have overcome their bias against franchising as they have come to understand how franchising works, but others remain intransigent.

Another warning is also in order. Once a franchisor registers or circulates its offering circular, it surrenders a good deal of its financial privacy and exposes a great deal of its proprietary information. Many owners of small to mid-sized businesses are reluctant to make such information publicly available. There is no franchise reporting system that is comparable to the reporting required by the SEC --and those who want information about a particular franchisor without paying a hefty fee might have to obtain that information under a state Freedom of Information Act procedure. There are, however, private businesses that offer comprehensive information about franchisor filings nationwide for a substantial fee.

What can be done to limit this outflow of information that the franchisor would like to keep confidential? One possibility is for the company that seeks to franchise to organize a separate entity, which will act as the franchisor. Note that if the ownership of the two companies is identical, an affiliation is created that would have to be reported in the UFOC and the affiliate's audited financial institution might have to be disclosed.

If the new franchisor is kept as separate as possible from its sponsor, with its own officers and directors, separate bank accounts, etc., it should have adequate legal substance to demonstrate the separateness of its business. The new entity can then file the UFOC and provide its own responses to the various Items in the UFOC, including its own financial statements. Since the new entity will have no financial history, other than a cash deposit, preparing audited figures will not be as challenging (or expensive).

A question that often arises in this setting is how much funding should be made available to the new franchisor? One rule of thumb suggests that the new company should have enough money to cover its obligations to its franchisees for training, opening expenses, advertising, guidance, etc. However, in some jurisdictions the regulators will be satisfied if the new company has in the bank an amount equal to the initial franchise fee it will charge one new franchisee. States with stricter regulations may require escrowing of the franchise fee until it is satisfied that the franchisor can meet its obligations to the franchisee.

Another advantage of franchising is the ability of franchisors to shift to their franchisees the costs and responsibilities of complying with local laws, payroll taxes, sales and use taxes, permits, zoning compliance, insurance, and many similar matters. What the franchisor cannot shift to the franchisee is the burden of supervising the franchise system. A franchisor must have a supervisory staff which provides visits to each unit, offers additional training, tests compliance, and anticipates problems within the system. An effective cadre of supervisors can help the franchisor avoid many problems in their incipiency.

Another cost that cannot be shifted is the cost of selling franchises. In some companies, salespersons are hired for the sole purpose of selling franchises. In others, franchise brokers are employed. Some approve the use of brokers because the brokers might have too many franchise offerings to sell and their sales people might not have sufficient time to devote to each client, or because the broker has conflicting obligations. Also, there is some risk that a broker might be tempted to make representations that are not to be found in the UFOC under pressure to earn a commission.

In addition to the costs associated with building a franchise system, there are other limitations that must be taken into account. Primarily for antitrust law reasons, franchisors cannot dictate to franchisees the prices at which they sell goods or services; they cannot impose territorial or customer restrictions on the distribution of goods and services; they cannot tie the provision of goods or services to the sale of other goods or services; and, except in rare cases, they cannot restrict access to suppliers. These limitations can inhibit marketing flexibility and sometimes profit sources in the franchise system.

Fortunately, these restrictions are not quite as bad as they seem. Each of them can be ameliorated if not eliminated. For example, even though the franchisor may not dictate the franchisees' sales prices, it is free to seek to persuade, cajole, and pressure the franchisees to charge designated prices. Of course, the franchisee is free to resist this pressure but that isn't easy.

Regarding territorial or customer restrictions on distribution, it is true that limitations exist. However, exclusive territories are often granted to franchisees who are not permitted to conduct business outside those territories. Similarly, certain customer restrictions are permitted where business justifications outweigh any adverse effect on competition.

As to tying the sale of one product to the purchase of another, complex antitrust rules are implicated. They are covered in Chapter 4. It is sufficient to say here that there is considerable latitude under the antitrust laws that cover tying, especially where the party seeking to impose the tie possesses minimal market power.

As to the franchisor limiting the franchisee's access to suppliers, once again there is room to maneuver. A franchisor has an obligation to protect its trademarks. Indeed, if it does not do so by maintaining quality standards with which the mark is associated, the franchisor may be deemed to have abandoned the mark. To protect its trademarks, franchisors have the right --and the obligation --to insist that the goods sold by their franchisees meet the quality standards set by the franchisor to protect its marks. With these concerns in mind, franchisors are usually very careful about the qualifications of the vendors who supply their franchisees. Typically, franchisors will offer franchisees a list of suitable vendors, whose products have met the franchisor's requirements. In many systems franchisees are free to suggest additional vendors, and then the franchisor is obligated to test the products of that vendor and determine if its products meet the system's standards.

Some franchisors have found themselves in a great deal of trouble when they passed off to their franchisees products they claimed were unique or specially prepared to meet the specific needs of the system when, in fact, they were not. In one case, a pizza franchisor made claims that its pizza sauce contained special ingredients and was cooked in a special way to provide unique flavor and other qualities. One of the franchisees in the system found that a commercially available pizza sauce had identical qualities and cost a great deal less than the sauce he was compelled to purchase from his franchisor. Such conduct by a franchisor is fraudulent and can lead to severe sanctions.

However, some franchisors are so intent on assuring the quality of their franchisees' offerings that they have taken the trouble to patent their formulations. In one instance, the franchisor patented his pizza sauce. With a patent in hand, it was difficult for the franchisees to argue that the franchisor's product could be replaced by a cheaper product sold on the open market. The plausibility of obtaining such a "business process" patent has diminished because the U.S. Patent Office no longer freely grants such patents.
As has already been noted, franchising is highly regulated, and that too could be considered a disadvantage. Any prospective franchisor has to decide for itself whether the burdens of regulation are trumped by the advantages of franchising. Yes, franchise compliance involves a lot of paperwork and a great deal of legal and accounting expense. Nevertheless, regulation is hardly unique to franchising and the legal and accounting expenses have not dampened the phenomenal growth of franchising.

There are a few other disadvantages of franchising that should be mentioned in passing. These include potential exposure to vicarious liability (a customer slips in front of the franchisee's store and sues the franchisor for negligence) possible misuse by franchisees of the franchisor's trademarks; and the relative inflexibility built into long-term franchise agreements that might prevent a system from being responsive to changing market conditions.

| | | Case Law Review | | |

Distributor, Manufacturer May Share “Community of Interest”

Brio Corp. v. Meccano S. N., DC WIS.

A "community of interest" under the meaning of the Wisconsin Fair Dealership Law (WFDL) could have existed between a Wisconsin toy distributor and a French manufacturer, the federal district court in Milwaukee has decided. The distributor raised several genuine issues of material fact as to whether a "community of interest" existed on the manufacturer's motion for summary judgment on the distributor's WFDL claims. Thus, the motion was denied and the dispute would proceed to trial.

In 2001, the distributor became the manufacturer's exclusive toy distributor for the United States. The manufacturer unilaterally terminated the distribution relationship in 2006, and the distributor brought suit. The distributor alleged that the manufacturer failed to comply with the notice and "good cause" provisions of the WFDL, and failed to repurchase all of the distributor's inventory of the manufacturer's toys at the fair wholesale market value. The manufacturer argued that the distributor was not entitled to the protections of the WFDL because, among other reasons, there was no "community of interest" between the parties.

There was a genuine issue of material fact as to whether the relationship was the type of intertwined dependent relationship the WFDL was designed to protect, the court ruled. The agreement imposed substantial obligations on the distributor to buy, sell, and promote the manufacturer's products. The agreement specified minimum purchase quotas and minimum sales, the court noted. The distributor was required to maintain appropriate inventory levels and was not allowed to distribute toys that competed against the manufacturer's toys. However, the distributor could sell its own brand of toys.

The court also concluded that the distributor raised a genuine issue of fact as to whether the percentage of time or revenue the distributor devoted to the manufacturer's products constituted a community of interest. The percentage of gross proceeds or profits the alleged dealer derived from the alleged grantor's products or services and the distributor contended that nearly 21% of its entire business was derived from sales of the manufacturer's products. In 2001, those sales accounted for 6.7% of the distributor's total sales, increasing to 16.5% in 2002, 26.2% in 2003, 32.1% in 2004, and 37.7% in 2005, the court observed. However, the manufacturer looked to the sales of its products in Wisconsin, not nationwide. Nevertheless, for its community of interest analysis the focus should be on the distributor's overall nationwide sales, according to the court. The distributor was granted an exclusive territory that encompassed the entire United States and whether the distributor's damages would be limited to those resulting from its sales of the manufacturer's products in Wisconsin was left for another day. On balance, the distributor's sales of the manufacturer's products accounted for over 20% of its business and that weighed slightly in favor of finding a community of interest.

The fact that the distributor had the exclusive right to sell the manufacturer's Erector brand of toys in the United States weighed heavily in favor of finding a community of interest. The distributor used the manufacturer's brand name as part of its efforts to sell the products but it did not use the name on its exterior signage or on its vehicles. Such use appeared to be *de minimus* and the facet did not satisfy the WFDL, the court held. The parties contested whether or not the distributor was forced to purchase undesirable product that was ill-liquid. The distributor's warehouse, which was rental property, was not devoted exclusively to the manufacturer's products and was adaptable to other uses upon termination of the parties' agreement. The distributor raised a genuine issue of material fact regarding its investment in inventory but not in physical facilities or goodwill.

The distributor raised a genuine issue of material fact as to whether the amount of time that its personnel devoted to the manufacturer helped to establish a community of interest. The distributor had one employee who worked solely on the manufacturer's products and contended that every one of its employees worked in furtherance of sales of the manufacturer's products. The distributor alleged that it spent $150,000 annually to present the products at a toy fair, $80,000 annually to lease a showroom at a toy fair, and $85,000 to $90,000 annually in marketing expenses, raising an issue of fact about whether its expenditures on advertising and promotion supported a community of interest. Finally, the distributor had one dedicated employee who dealt with customer complaints related to the manufacturer's products, such as returns and warranty issues, and raised a genuine issue of material fact as to whether the supplementary services it provided favored a finding of a community of interest.

Considering all of the circumstances in a light most favorable to the distributor, while it was not exclusively dependent upon the manufacturer, the relationship and the resultant revenues were significant to its business, the court decided. The distributor contended that the termination caused such a significant impact on its business that the business collapsed, in other words, the distributor alleged that the manufacturer had it "over a barrel." However, the reason for the distributor's ultimate demise was contested. Thus, the case was allowed to proceed to trial.

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Franchisor's Printing Services For Franchisee Were Not Taxable by City

Mesa v. Val-Pak East Valley, Inc., Ariz. Ct. App

The printing services provided by a Florida direct mail solicitation business franchisor to its Arizona franchisee were not subject to the City of Mesa, Arizona's use tax, an Arizona appellate court has held. Under two alternative analyses, the printing services provided by the franchisor were non-taxable services. Thus, a ruling by the Arizona Tax Court was reversed.

The Mesa City Code levied "an excise tax on the storage or use in the City of tangible personal property," and that the tax was owed by "[a]ny person who acquires tangible personal property from a retailer, whether or not such retailer is located in this City, when such person stores or uses said property within the City." Pursuant to the franchise agreement, the franchisor created and printed coupons, put them into envelopes, and mailed them from Florida to addresses as directed by the franchisee.

Under the dominant purpose test, if the dominant purpose of the transaction was a service, then the transaction was not taxable, the court noted. The city conceded that the cost of the paper accounted for only nine percent of the amount of the invoices that the franchisor sent to the franchisee for the printing. Thus, under that analysis, the dominant purpose of the transaction was a service --job printing --not the purchase of tangible personal property, the court determined.

Whether a transaction qualified as the sale of tangible personal property or the sale of a service under the common understanding test was determined by the parties' common understanding of the particular trade, business, or occupation. The coupons that the franchisor produced contained advertising that it created and printed specifically on the franchisee's order for the franchisee's clients. Beyond the creation and printing of the coupons, the franchisor also provided the additional service of packing the coupons into envelopes and mailing them to addresses specified by the franchisee. Thus, the common understanding of the transaction was that the franchisee and the franchisor contracted for a service, not an item of tangible personal property, the court held.