

Hidden Franchises: Definitions and Consequences

Presented to

Orange County Bar Association

Corporate and Business Law Section

By

Gerard P. Davey and James M. Mulcahy

August 23, 2006

Overview

- Franchising – Definitions and Regulatory Overview – Gerry Davey
- Consequences and Remedies for Non-compliance – Jim Mulcahy
- Questions and Answers

Definitions of “Franchising”

- Federal Trade Commission’s Trade Regulation Rule on Franchising (16 C.F.R. Section 436.1 et. seq. (1983))
- California Franchise Investment Law (Calif. Corp. Code, Section 31,000 et seq.); California Franchise Relations Act (California Bus. & Prof. Code, Section 20,000 et seq.)
- Other state and federal franchise laws

FTC Franchise Rule: Scope

- Product and Business Format Franchises
 - Product Types: beverage bottlers, etc.
 - Business Format: fast food, business services, etc.
- Business opportunity ventures: vending machine routes, chinchilla farms, etc.
- Disclosure requirement only; no registration or filing requirements

FTC Rule: Definition of Franchise

- Three Elements Required
 - Trademark usage in substantial association with licensee's business
 - Payment of fee (any consideration) in excess of \$500 within first 6 months of relationship
 - Offer of significant assistance to or exercise of significant control of licensee's business
- Agreement must be in writing

CFIL: Definition of Franchise

- Three (Four?) Elements
 - Right to engage in a business under a marketing plan or system prescribed in substantial part by the franchisor
 - Franchisee's business is substantially associated with the franchisor's trademark
 - Franchisee required to pay, directly or indirectly, a franchise fee (\$1,000 per year)
- Registration with Dept. of Corp. required

Other Legal Definitions of Franchise

- California Franchise Relations Act – similar to CFIL
- Other State Franchise Laws – “Community of Interest” concept
- Specialty Laws – Auto dealers, gas stations, beer distributors, etc.

Regulatory Interpretations: Definition of a Franchise

- Regulatory Guidelines
 - FTC Interpretative Guidelines -- **Final Interpretative Guides: 44 FR 49966-49992 (Aug. 24, 1979)**
 - California Guidelines – Commissioner's Releases (**Release No. 3-F (Revised by the California Department of Corporations: "Guidelines for Determining Whether an Agreement Constitutes a Franchise")**)

Judicial Interpretations: Definition of a Franchise

- Kim v Servosnax, 10 Cal App 4th 1346 (1992)
- Gentis v Safeguard, 61 Cal App 4th 868A (1998)
- People v Gonda, 138 Cal App 3d 774 (1983)
- Neptune Society v Longanecker, 194 Cal App 3d 1233 (1987)

Semantics and Franchising

- Clever students of Dr. Peter Mark Roget are many times awarded extended sabbaticals at the “Gray Bar” Hotel
- Like the man said: Even though you hung the “Horse” sign on the cow, it’s still a cow!

So it's a Franchise: Now What?

- Compliance with FTC Rule:
 - Nationwide application
 - Comprehensive pre-sale disclosure requirements – UFOC (23 items)
 - Annual and periodic update requirements
 - No filing requirement – self policing
 - FTC Enforcement only; No private action

So it's a Franchise: Now What?

- Compliance with CFIL:
 - All California transactions
 - Comprehensive pre-sale disclosure requirements (Basically same as FTC version with state amendments)
 - Annual and periodic update requirements
 - Permit from DOC required
 - DOC Enforcement and private action

So it's a Franchise: Now What?

- Compliance with Laws outside of California:
 - 13 other states with similar franchise registration and disclosure laws
 - Separate franchise filings in each state
 - Compliance potentially with various other business opportunity laws

Franchise Resource Information

- FTC Franchise Website
 - <http://www.ftc.gov/bcp/franchise/netfran.htm>
- California DOC Website
 - <http://www.corp.ca.gov/srd/franchise.htm>
 - <http://www.corp.ca.gov/caleasi/caleasi.htm>

Internet Access to Information Related to Franchising

- **PACER System**
 - <http://pacer.psc.uscourts.gov>
- **EDGAR System**
 - <http://www.sec.gov/edgar/searchedgar/companysearch.html>
- **Cal-EASI System**
 - <http://www.corp.ca.gov/caleasi/caleasi.htm>
- **TESS System**
 - <http://www.uspto.gov/main/trademarks.htm>
- **PatFT System**
 - <http://www.uspto.gov/patft/index.html>
- **LOCIS Search System**
 - <http://www.copyright.gov/records/>
- **Google**
 - <http://www.google.com>

Consequences and Remedies for Non-Compliance

- Private Litigation
- Regulatory Enforcement by DOC

Private Litigation – Cause of Action

- § 31300 – Civil liability for:
 - Offer or sale of unregistered franchise;
 - Sale of franchise without delivery of offering circular at least 10 days before the earlier of either signing franchise agreement or receipt of any consideration
 - Any untrue statement of material fact or omission in any document filed with DOC

Cause of Action

- § 31301 – Civil liability for:
 - Any other oral or written misrepresentation of material fact or omission which was relied upon by purchaser of franchise

Persons Liable

- § 31302 – All of the following:
 - Persons who committed the violation
 - All direct or indirect controlling persons
 - All partners
 - All principal executive officers
 - All directors
 - Each employee who materially aided in the acts constituting the violation
 - All persons who performed similar functions

Remedies

- Damages causally related to violation
- Rescission, if willful
 - Not for § 31301
- Possible joint and several liability

DOC Commissioner can:

§ 31400

- File civil lawsuits or request the Attorney General to do so

§ 31401

- Conduct investigations
- Publish information about violations

Remedies Available to DOC

- Injunctions
- Seek appointment of receiver
- Issue Desist & Refrain Order for offer or sale of franchise without registration
- Seek restitution or damages
- Seek civil penalties of up to \$2,500 for each violation

Remedies Available to DOC

- Refer evidence to county District Attorney for criminal prosecution
 - Fines up to \$100,000 and/or 1 year in state prison / county jail

Responding to DOC Investigative Subpoena

- Request opportunity to submit white paper with documents
 - Establish credibility
 - Do work for DOC
 - Address whether all or some transactions are really “franchises”
 - *i.e.*, company-owned stores, or joint ventures

Responding to DOC Investigative Subpoena

- Minimize impact of violation
 - Experienced franchisee exemption (§ 31106)
i.e., substantially similar business experience
- If possible, emphasize no harm to franchisees
 - Franchisee declarations
 - Releases

Responding to DOC Investigative Subpoena

- Show that violations will not continue
 - *i.e.*, registration in progress

Responding to DOC Desist & Refrain Order

- Request for hearing
 - ALJ conducts hearing and makes recommendations to DOC
 - Appeal to Superior Court
- Practical consequences
 - Can take up to or over a year
 - Impact on business

Consequences

- If registration / disclosure violation, then possible notice of violation and offer of rescission
- If fraud / deceit, then more problematic

James M. Mulcahy

Franchise & Antitrust Litigation Attorney

James Mulcahy, of The Mulcahy Law Firm, specializes in franchise and distribution, antitrust / competition and related intellectual property litigation. The Mulcahy Law Firm represents manufacturers and franchisors in their dealings with competitors, franchisees, distributors, dealers, suppliers, government agencies and others. In addition, Mr. Mulcahy litigates and counsels clients concerning California's Cartwright Act and Unfair Competition Act, as well as the federal Sherman, Clayton and Robinson-Patman Acts.

Mr. Mulcahy has been active for a number of years in various bar organizations. He currently serves as Co-Chair of the Franchise Law Committee, and is also a member of the Los Angeles, Orange County, and American (*Distribution and Franchising Committee, Antitrust Law Section and Forum on Franchising*) Bar Associations.

Mr. Mulcahy speaks regularly before bar and business organizations on topics of franchise and distribution law. He has authored or co-authored a number of legal articles and publications on franchise and other methods of distribution. His articles published in 2006 include: Franchise Agreement Drafting – Basic Tracks as part of the International Franchise Association's Annual Symposium in May 2006; and Recent Decisions and Legislation: California Franchise and Distribution published in the June 2006 edition of Business Law News for the California State Bar, Business Law Section. Mr. Mulcahy is also a contributing author of the chapter on tying arrangements in Antitrust Law and Economics of Product Distribution, published in 2006 by the American Bar Association, Antitrust Law Section.

James M. Mulcahy
Franchise & Antitrust Litigation Attorney

Mr. Mulcahy's previous publications include: Exclusive Distributorships and Dual Distribution: How to Avoid Dealer Litigation, which appeared in the November 2002 issue of the Orange County California Lawyer; Current Developments in Franchise Law for the Business Law Section, Franchise Law Committee, California State Bar Association in March 2003; Hot Topics in Franchise Litigation as part of the California State Bar's 77th Annual Meetings in September 2004; and Hot Topics in Franchise Litigation as part of the California State Bar's 78th Annual Meetings in September 2005.

James M. Mulcahy
THE MULCAHY LAW FIRM
1 Park Plaza – Suite 225
Irvine, California 92614

Tel.: 949-252-9377

Fax.: 949-252-0090

E-mail: jmulcahy@mulcahylaw.com

Gerard P. Davey

Franchise Attorney

Mr. Davey has been practicing law for more than 30 years, specializing in business law, franchising and commercial leasing. In his practice in Costa Mesa, he has represented many businesses, both publicly-held corporations and private entrepreneurs, as well as numerous franchisors and franchisees, involving creation and development of franchise programs and agreements, franchise registrations, business sales and mergers, business and franchise disputes, employment issues and various other franchise and distribution issues. He has also served as a mediator, arbitrator and expert witness in numerous franchised related legal proceedings.

Mr. Davey formerly served as Vice President/Corporate Counsel for both Century 21 Real Estate and Coldwell Banker Real Estate.

He is active in business law education and legislative issues. He has lectured on numerous franchise and business law topics for the CEB, the International Franchise Association, the State Bar of California and other business groups. He is the Co-Chairman of the Franchise Law Committee of the California Bar Association, and he is the author of several California laws regarding franchising and lending matters, including California Corporations Code, Section 31108 and California Financial Code, Section 22063.

GERARD P. DAVEY

A Professional Law Corporation
650 TOWN CENTER DRIVE, SUITE 550
COSTA MESA, CALIFORNIA 92626
(714) 434-9100/FAX: (714) 434-9111
E-MAIL: GDavey@DaveyLaw.com