

Inadvertent Franchises and the GrayBar Hotel

This article first appeared in *Orange County Lawyer* magazine in June 2010, Vol. 52 No. 6 (page 18).
© Copyright 2010 Orange County Bar Association.

The views expressed herein are those of the author(s). They do not necessarily represent the views of the *Orange County Lawyer* magazine, the Orange County Bar Association or its staff.

All legal and other issues should be independently researched.

by Gerard P. Davey and
James M. Mulcahy

Misjudgments about what constitutes a “franchise” can sometimes lead to disastrous consequences. In the case of John Gonda, such a misjudgment resulted in a criminal conviction for the sale of unregistered franchises in California. *People v. Gonda*, 138 Cal.App.3d 774 (1983). In *Gonda*, the California Court of Appeals found that the trial court properly excluded testimony of a business attorney whom the defendants had consulted and who allegedly advised them that “their contract

was not a registrable franchise and ‘they therefore were not breaking any laws.’” The Court concluded that: “Reliance on advice of counsel provides no defenses to the charges here.” Incompetent legal advice has potential implications for more than just the personal liberty of clients. It may impact the giving legal advice, as well.

In a Connecticut case, the misjudgments about whether a franchise should be registered under the Connecticut business opportunity law led to disastrous consequences for a law firm. In the case of *Beverly Hills Concepts, Inc. v. Schatz & Schatz, Ribicoff & Kotkin*, 247 Conn. 48 (1998), the Court affirmed a \$16 million malpractice judgment against a Connecticut

law firm, which had misjudged whether or not to register a franchise concept under the Connecticut business opportunity laws. The court concluded that the “claims by the defendants that Goldman (partner in the defendant law firm) analyzed the situation and declared that BHC (plaintiff) was operating in a gray area was, in the face of the overwhelming evidence available to him, only further evidence of incompetence.”

FTC Definition of “Franchise”

So how is a “franchise” defined under the law? The term “franchise” is variously defined under FTC regulations, franchise laws of California, and more than a dozen other states, the business opportunity laws of more than two dozen states, and various other federal and state industry specific laws concerning franchising.

Under the *FTC Franchise Rule* (16 *CFR* Part 436, *hereinafter* “*FTC Rule*”), a “franchise” is defined to include a relationship with three key elements, as follows: “Franchise” means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that: 1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor’s trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor’s trademark; 2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee’s method of operation, or provide significant assistance in the franchisee’s method of operation; and 3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate. (16 *CFR* 436.1 (h)).

Under the *FTC Rule*, a “required payment” means all consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise.”

A required payment is exempt if the total of the required payments, or commitments to make a required payment, to the franchisor or an affiliate that is made any time before the

agreement is signed or within six months after commencing operation of the franchisee’s business is less than \$500. 16 *CFR* 436.8 (a)(1).

A required payment also does not include payments for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale or lease. 16 *CFR* 436.1(s).

All three elements must be present in the relationship in order for the *FTC Rule* to apply. If any of these three elements is missing, the transaction is not subject to the *FTC Rule*. If all of the elements are present, the *FTC Rule* applies, regardless of any disclaimers, waivers, releases, or acknowledgments that the relationship does not constitute a “franchise.” In fact, the use of express disclaimers can be counterproductive and dangerous, as the use of such disclaimers may evidence foreknowledge of the likeness of the relationship to the definition of a “franchise.”

FTC Disclosure Requirements

If a business relationship constitutes a “franchise” under the *FTC Rule*, then the franchisor must comply with the disclosure requirements under the *FTC Rule*, which basically requires that the franchisor prepares a “Franchise Disclosure Document” (“*FDD*,” which is comprised of a comprehensive offering prospectus describing the franchise opportunity, investment estimates and fees charged, as well as information about the franchisor, its management, its litigation, and bankruptcy history, its financial condition, and other relevant information, in accordance with the disclosure guidelines under the *FTC Rule*). The franchisor is required to deliver the complete *FDD* to each prospective franchisee upon the request of such prospective franchisee, but in no case later than 14 calendar days before the earlier of the date any agreement is signed or any payment is made by the prospective franchisee. 16 *CFR* 436.2. There is no filing or registration requirement under the *FTC Rule*.

FTC Remedies— No Private Cause of Action

Failure of a franchisor to comply with the *FTC Rule* constitutes an unfair or deceptive act or practice (16 *CFR* 436.2) in violation of Section 5 of the *Federal Trade Commission Act*. 15 *U.S.C.* §45.

Although the FTC wields an impressive panoply of remedies against violators of the *FTC Rule*, including injunctive action, civil penalties, restitution action for victims, seizure of property action, personal liability, and other remedies, there is no private cause of action for violation of the *FTC Rule*. *Days Inns of America Franchising, Inc. v. Robert T. Windham*, U.S. District Court, Northern District of Georgia, Atlanta Division. Civil 88-CV-1641-MHS, filed November 28, 1988 (*CCH Bus.Fran.Guide* ¶9296). There is, however, authority in a number of states, holding that a violation of the *FTC Rule* constitutes a concomitant violation of the applicable “*Little FTC Act*” under such state’s laws. *Theodore R. Morgan v. Air Brook Limousine, Inc.*, *New Jersey Superior Court, Law Division, Essex County*, Dkt. No.L 68857-84, decided January 31, 1986 (*CCH Bus.Fran.Guide* ¶8560). Further information regarding the *FTC Rule* can be found at the FTC’s Franchise and Business Opportunities website (<http://www.ftc.gov/bcp/menus/consumer/invest/business.shtml>), which also includes the *FTC Franchise Rule Compliance Guide* (<http://www.ftc.gov/bcp/edu/pubs/business/franchise/bus70.pdf>) and the Amended Franchise Rule FAQs (<http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml>).

California Definition of “Franchise”

Under the *California Franchise Investment Law* (“*FIL*”) (*California Corporations Code* (“*CCC*”), §31100, *et seq.*), a “franchise” is defined to include three elements (defined slightly differently than the FTC definition), as follows . . . a) “Franchise” means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which: 1) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and 2) The operation of the franchisee’s business pursuant to such plan or system is substantially associated with the franchisor’s trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate; and 3) The franchisee is required to pay, directly or indirectly, a franchise fee. *CCC* 31105.

Neither the payment of a franchise fee or

other consideration of less than \$500 per year nor the payment for the purchase or rental of fixtures, equipment or other tangible property to be utilized in, and necessary for, the operation of the franchised business in an amount of less than \$1,000 per year will be regarded as a "franchise fee." *California Administrative Code* Title 10, §§310.011 and 310.011.1.

Also, similar to the exception under the *FTC Rule*, the *bona fide* wholesale price charged to a purchaser or dealer for reasonable quantities of inventory sold in connection with the operation of the purchaser or dealer's business will generally not constitute a "franchise fee." *CCC* §31011.

Similar to the *FTC Rule*, all three California elements must be present in the relationship in order for the *FIL* to apply. While the definitional elements of any "franchise" may appear to be different under the *FTC Rule* compared to the *FIL*, they are in application very similar. Both identify a "trademark element" and a "fee element." Additionally, a careful analysis of the *FTC Rule* "significant control/assistance element" compared to the *FIL* "prescribed marketing plan element" will reveal that the requirements are very similar. In most cases, facts constituting the indicia of the *FTC Rule* "significant control/assistance element" will also serve as indicia of the *FIL* "prescribed marketing plan element." Rarely will a transaction constitute a "franchise" under one definition but not the other.

California Registration and Disclosure Requirements

If a business relationship constitutes a "franchise" under the *FIL*, then the franchisor must comply not only with the disclosure requirements under the *FIL*, which are similar to the *FTC Rule* disclosure requirements, but also with the registration requirements under the *FIL*. It is a violation under the *FIL* to offer or sell any franchise in California unless the franchisor has first obtained a franchise registration permit from the California Department of Corporations ("DOC") (*CCC* §31110) and unless the franchisor has delivered a comprehensive FDD (as approved by the DOC) on a date that is fourteen calendar days before the earlier of the date any agreement is signed or any payment is made by the prospective franchisee. *CCC* §31119.

Further information regarding the *FIL* and the regulation of franchises in California can be found at the DOC's website at <http://www.corp.ca.gov/SRD/franchise.asp>, which also contains a link to DOC Release 3F (the seminal policy statement by the DOC as to what constitutes a "franchise" under the *FIL*) (<http://www.corp.ca.gov/Commissioner/Releases/3-F.asp>).

Other Definitions of "Franchise"

There are other legal definitions of a "franchise." For example, the *California Franchise Relations Act (California Business & Professions Code, §20000, et seq.)* defines a "franchise" slightly differently than under the *FIL*. In some states, such as Hawaii, Minnesota, South Dakota, and Washington, the "prescribed marketing plan" element is replaced with an element determining whether the franchisor and franchisee share a "community of interest" in marketing the franchised goods and services.

Private Litigation Under the FIL

Unlike the *FTC*, the *FIL* provides individual franchisees and sub-franchisors with a private right of action against the franchisor. *CCC* §31330. This private right of action arises if the franchisor: 1) offers or attempts to sell a franchise without first registering with the State (*CCC* §31110); 2) fails to provide the prospective franchisee with the FDD at least 14 calendar days before the earlier of either signing the franchise agreement or receiving any payment for the franchise (*CCC* §31119); 3) files a document with the DOC that contains any material inaccuracies (*CCC* §31200); or 4) sells a franchise through the use of any oral or written misrepresentation of material fact or omission on which the purchaser relied. *CCC* §31202.

Persons Liable

A violation of the *FIL* not only provides the franchisee with a private right of action against the franchisor, but it also may allow the franchisee to name as individual defendants employees and others associated with the franchisor. *CCC* §31302. Those facing potential liability are directors, partners, executive officers, and all other persons who committed or participated in the violation. Further, liability for these individual defendants is joint and several with that of the fran-

chisor or any other liable person. The franchisee may recover all of the damages from any of the individual defendants regardless of their individual share of the liability.

The only defense available to an individual defendant faced with shared liability of the franchisor requires that person to show that he or she had no knowledge of or reasonable grounds to believe that the facts giving rise to the alleged liability exist. *Spahn v. Guild Industries Corp.*, 4 Cal.App.3d 143,158 (1979).

Remedies Under the FIL

In an action for violation of the *FIL*, the franchisee must prove that the damages are causally related to the violation and are not speculative or without foundation. However, if the franchisor's violation is considered willful, the franchisee may also rescind the franchise agreement and unwind the franchise transaction altogether. *CCC* §31301.

Statute of Limitations

Typically, a franchisee can bring a private right of action for violation of the registration or FDD requirements under the *FIL* before the expiration of four years after the act that constituted the violation, one year after the franchisee discovers such act, or 90 days after the franchisor delivers to the franchisee notice of any violation, whichever occurs first. The one-year period of limitations begins to run from the date that the franchisee knows of the facts constituting a violation even if it is unaware that a violation has actually occurred. If a claim is premised upon the untrue statement of a material fact in any non-filed materials (e.g., advertising materials, etc.), a two-year period replaces the four-year period. *CCC* §31304. Once the four-year or two-year period expires, a franchisee's belated discovery of facts constituting a violation does not extend the limitation period. *People ex rel. Dept. of Corporations v. Speedee Oil Change Systems, Inc.*, 95 Cal.App.4th 709 (2002). In other words, the four-year bar in *CCC* §31303 and the two-year limit in *CCC* §31304 are absolute.

DOC Enforcement Actions

The DOC is responsible for enforcing the state's franchise laws. *CCC* §31400, *et seq.* The DOC's enforcement authority is extremely wide-ranging and includes broad investigatory power.

Failing to respond appropriately and timely to DOC inquiries can result in a desist and refrain order that could be devastating to a business' marketing program.

Remedies Available to the DOC

The DOC has the statutory authority to seek a number of remedies, including: 1) filing a civil lawsuit or requesting that the Attorney General do so; 2) conducting investigations; 3) publishing information about violations of the *FIL*; 4) seeking injunctions; 5) issuing a stop order to stop the offer or sale of a franchise that has not registered with the State; 6) seeking restitution or damages; 7) issuing desist & refrain orders; 8) seeking appointment of a receiver; and/or 9) seeking civil penalties of up to \$2,500 per violation. *CCC* §31400, *et seq.*

In addition, the DOC has the authority to refer evidence to a County District Attorney or the California Attorney General for criminal prosecution if the business' alleged violation is willful. *CCC* §31410. A criminal charge can result in fines of up to \$100,000 and up to a year in a state prison or county jail. *CCC* §31411. As in a private action, the DOC has the authority to enforce its available remedies against the owners and officers of the franchisor who willfully violate the *FIL*. See *Neptune Soc'y Corp. v Longanecker*, 194 Cal.App.3d 1233, 1247 (1987).

In short, the DOC's ability to apply powerful remedies makes it extremely important that businesses retain experienced counsel to handle an investigation.

Potential Areas of DOC Inquiry

A DOC inquiry will generally involve one of three areas of alleged client noncompliance with the *FIL*. First, the DOC often investigates businesses that appear to qualify as franchises under the *FIL* but that have not registered with the DOC, as required. As noted above, any arrangement that possesses the three elements stated in the *FIL* will be deemed a franchise regardless of any label or disclaimer. *CCC* §31005. Second, the DOC investigates registered franchisors that have failed to make the disclosures required by the *FIL*. *CCC* §31114. Finally, DOC investigations are often triggered by franchisee complaints of misrepresentations in franchisor disclosure documents. *CCC* §§31201-202, 31301.

Responding to a DOC Subpoena

The DOC is authorized to issue investigative subpoenas to collect evidence for its investigation, and failure to respond to such a subpoena can result in a contempt order. *CCC* §31401. Counsel should take several steps in the early stages of any DOC investigation. First, counsel should notify the DOC of his or her representation of the business in the matter. Second, counsel should assure the DOC that the target business will be conducting its own rigorous internal investigation of the DOC's allegations. Third, and most importantly, counsel should gather all of the requested information and provide it to the DOC. This generates goodwill with DOC investigators by saving them investigative resources and increasing their confidence in the business' ability to handle its issues internally.

The DOC representative handling the investigation will likely have substantial contact with counsel, and avoiding an adversarial relationship with this representative is important. Thus, the business should make every effort to appear cooperative and to act proactively to address the DOC's allegations. Counsel should respond as quickly as possible to a subpoena, but if additional time is needed to make the proper disclosures, he or she should request a time extension immediately and provide a reasonable explanation as to why more time is needed.

Counsel should also request permission to submit a comprehensive written response to the inquiry ("white paper"). Combined with helpful disclosure responses, a written response can establish the franchisor's credibility with the DOC. The white paper should describe the franchisor's history, operations and accomplishments, and explain its business model.

The white paper should be tailored to the DOC's specific allegations in the matter. Common issues to address include: 1) whether the client is a franchise under the *FIL*; 2) possible application of a statute of limitations; and 3) possible exemptions from state filing requirements. If any violations have actually occurred, the paper should address these violations directly, and if the scope of the violation is limited to certain locations or business units, the paper should explain this. An effective white paper will emphasize that any such violations have permanently ended and under-

score the business' good faith and lack of intent to violate the franchise laws. If the business violated the *FIL* but no harm resulted, the white paper should accent this fact; if possible, the business should ask its putative franchisees for declarations to this effect.

Even if the DOC finds that a business violated the *FIL*, if the business cooperates with the DOC, produces the requested evidence promptly and produces a paper emphasizing the business' attempts to comply with the *FIL* in the future, penalties arising from investigations launched by the DOC can be greatly minimized.

Finally, it is important to remember that the livelihood of a business could be dependent on its response to a DOC investigation. As such, it is important that businesses retain expert outside counsel experienced in handling franchise matters before the DOC.

In Perspective

Both private actions and DOC enforcement actions have the potential to dramatically alter a client's business. Worse, a client may find himself or herself personally liable or, most alarmingly, facing the possibility of a prison sentence. Any business person venturing into the realm of "licensing," or similar arrangements, should make a careful analysis of the limits of the "gray area" to avoid an extended stay at the GrayBar Hotel.



Gerard P. Davey specializes in franchise and business law. He is a Certified Specialist in Franchise and Distribution Law by the State Bar of California Board of Legal Specialization. His contact information is gdavey@daveylaw.com; Web www.daveylaw.com. James M. Mulcahy specializes in franchise and distribution litigation. He is a Certified Specialist in Franchise and Distribution Law by the State Bar of California Board of Legal Specialization. His contact information is email jmulcahy@mulcabyllp.com; Web www.mulcabyllp.com.