CANADIAN AND OTHER FOREIGN COMPANIES SELLING INTO THE UNITED STATES THROUGH INTERMEDIARIES: BEWARE OF FRANCHISE AND OTHER DISTRIBUTION LAWS

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A Canadian or other foreign company looking to obtain a presence in the United States market without having to set up its own U.S. sales operation may consider using intermediaries to sell its products or services in the U.S.. The most common types of intermediaries are independent distributors and sales representatives. A distributor typically purchases the foreign company's product, imports it into the U.S., and then sells the product to end users. The distributor often provides buyer financing and handles after-sales service and warranty needs. A sales representative, rather, typically acts as an independent agent who sells the foreign company's product on commission but does not at any point own the product. The sales representative often solicits orders within a specific geographic area, with the foreign company delivering those orders directly to the customer.

The use of an intermediary may allow a Canadian or other foreign company to gain an immediate presence in the U.S. market. However, distribution in the U.S. is subject to increasing legal regulation. As part of its export plan, the foreign company should examine any proposed distribution relationship with a U.S. intermediary, to determine whether the relationship will be subject to U.S. franchise or other distribution laws. This article discusses generally some of the laws regulating distribution in the U.S.

Franchise Laws

The U.S. federal government and about one third of the states regulate the offer and sale of franchises. Whenever a seller allows another party to operate under, or distribute goods or services associated with, the seller's trademark, service mark, trade name or other commercial symbol, franchise laws may apply to the relationship. Typically, when people think of franchises they think of established brands in traditional industries, such as the fast food and automotive industries. However, business arrangements not traditionally viewed as franchises may fall within a statutory definition of a franchise, including sales representative and distributor relationships.

The Federal Trade Commission's trade regulation rule on franchising (the "FTC Rule"), which applies to franchises throughout the U.S., requires franchisors to provide a franchise offering circular to prospective franchisees before any offer or sale is made, unless an exclusion or exemption applies. The offering circular contains comprehensive information about the franchisor, the franchise and the terms and conditions of the franchise contract. The offering circular is not required to be filed or registered with the federal government. However, 14 states do have franchise laws that require the franchisor to register its franchise with the state and receive approval from the state before offering to sell a franchise.

A number of states also have laws governing the ongoing business relationship between the franchisor and the franchisee. These laws include: (1) good cause requirements for early termination or non-renewal (such as failure to cure a breach of the franchise agreement after notice and a reasonable opportunity to cure), (2) mandatory compensation of franchisees upon non-renewal and (3) provisions regarding the transfer of ownership of the franchise.

The definition of a franchise varies under the applicable laws, although the definitions tend to have the following common elements: (1) the grant of a right to operate a business in association with the franchisor's trademark, service mark, trade name or other commercial symbol, (2) significant control or assistance by the franchisor (under state laws this element is often replaced with either the "community of interest" definition where some common financial interest exists between the parties in the operation of the franchised business or the "marketing plan" definition where the franchisor prescribes a marketing plan or system in substantial part) and (3) the franchisee is required to pay a franchise fee to the franchisor. The definition of a franchise fee has been interpreted broadly and includes any required payment made by the franchisee to the franchisor, including payments for sales and service manuals, promotional literature or a required purchase of excess inventory. Only a few exceptions are recognized, the most common being the payment for reasonable amounts of inventory at a bona fide wholesale price. All three elements must be present under the FTC Rule and the state franchise laws for a franchise to exist, except in New York where payment of a franchise fee combined with either one of the other two elements constitutes a franchise.

The state franchise laws and the FTC Rule provide various exclusions and exemptions based upon a policy determination that regulation is not needed to protect the public interest. The exemptions vary, and the laws of each applicable state should be examined in each case. For example, the FTC Rule excludes from the definition of a "franchise fee" payments of less than $500 required to be made within six months after the franchisee opens for business. Several states also have small payment exclusions. Additionally, several states including New York exempt franchisors from registration and disclosure requirements if the franchisor meets certain net worth tests. It should be noted that exemption under a particular state law does not exempt franchisors from application of the FTC Rule.

Absent an applicable exclusion or exemption, avoiding the application of U.S. federal and state franchise laws typically requires the careful avoidance of at least one element of the "franchise" definition (while recognizing that the definition is not the same in all jurisdictions). It should be noted that it does not matter what the parties call the relationship in their contract or other documents and protections afforded by the franchise laws generally cannot be waived. The name given to the relationship by the parties is irrelevant in the eyes of governmental regulators, who will look at the substance of the relationship. As discussed above, purchases of a seller's products would not be a franchise fee if they constitute a reasonable amount of inventory at a bona fide wholesale price. If the seller does not accept non-inventory payments of any kind from the sales representative or distributor or limits such payments to truly optional purchases from the seller, the potential application of most franchise laws may be avoided because there is no required franchise fee. Direct or indirect payments, including reimbursement for service manuals, brochures and other promotional items, should be avoided. If promotional items are costly to produce, it may be safer to have the sales representative or distributor buy those items directly from the printer or other supplier.

Business Opportunity Laws

Approximately half of the states have enacted business opportunity statutes which are meant to extend certain disclosure protections afforded to purchasers of franchises to those that purchase a business opportunity. The definition of a "business opportunity" is often broad and varies from state to state, although each statute generally has the following common elements: (1) an oral or written contract under which a seller provides products, services, equipment or supplies to enable the buyer to start a previously nonexistent business and (2) certain representations are made by the seller in connection with the marketing and sale of the business opportunity. Examples of representations made by the seller which have been relevant under business opportunity laws include where the seller represents that it will purchase the products made using the goods or services sold to the buyer and where the seller guarantees in writing that the buyer will derive income from the opportunity.

Business relationships which have been covered by the business opportunity laws include businesses involving sales of rack displays and vending machines, merchandise discount programs, home health care services and frozen pizza distributorships. If the relationship constitutes a business opportunity under the applicable state statute, that statute will typically require pre-sale registration and detailed disclosure documents. Certain states also require a merit review of the disclosure documents before they will be accepted for filing and a registration issued. Like the franchise laws, there are exemptions from the business opportunity laws available.

Sales Representative Laws

About 35 states have laws that regulate the business relationship between a supplier and the sales representative that promotes the supplier's products. These laws do not have registration or disclosure requirements like the franchise and business opportunity laws discussed above, but they do provide substantial remedies (including recovery of double or treble damages, costs and attorneys' fees) if they are violated. These laws are designed to help ensure that the representative is fairly compensated in accordance with the agreement between the parties and often deal with the payment of commissions upon termination of the sales representative agreement. Some of these laws require that all agreements be in writing or that a copy of the agreement be delivered to the sales representative. Some also deal with how payments during the term of the agreement are to be calculated and paid, although generally the terms of the agreement control.

Dealership Laws

Wisconsin has a law specifically governing the relationship between dealers (which may include both sales representatives and distributors) and manufacturers which requires good cause for termination of the dealer. Additionally, four states have franchise laws that define the term “franchise” without a fee element and may apply to dealer relationships. These laws also require good cause for termination.

Industry-Specific Laws

There are a wide variety of industry-specific laws in the U.S. that regulate the relationship between a manufacturer or supplier and the distributor or dealer. Some examples include laws governing petroleum marketers, automobile dealerships, recreational equipment dealers, farm equipment dealers and liquor and wine distributorships. Most of these laws require good cause in addition to notice for termination.

Conclusion

A Canadian or other foreign company should examine each proposed distribution relationship with a U.S. intermediary to determine whether the relationship will be subject to U.S. distribution laws. If the intermediary will have a large territory, more than one of these laws may apply and each should be reviewed before the relationship is entered into by the foreign company. If possible, the foreign company should structure the relationship so as to legitimately avoid application of applicable distribution laws (typically by avoiding one of the definitional elements of the law or qualifying for an available exemption) because complying with those laws can be time consuming and expensive, especially in the case of franchise and business opportunity laws. Additionally, failure to comply with applicable U.S. distribution laws can be costly, as non-complying companies and even their owners, officers and directors may, depending on the particular law, be subject to remedies including actions for damages, injunctions, rescission, civil fines and criminal penalties.

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