

Legal Issues in Non-Traditional Development: An Overview

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What Is It?

- Non-traditional development involves offering goods and services from a location or in a format that differs from what the franchise system typically does. Examples include co-branding with other concepts, kiosks, other satellite locations and e-commerce.

Why Engage in Non-Traditional Development?

- **Mature Markets.** Non-traditional distribution provides an avenue for increasing system sales when markets for traditional outlets are at or near saturation.
- **Reduced Costs/Improved Margins.** Non-traditional outlets may offer lower operating costs and may be less susceptible to "value pricing" demands, thus allowing better margins.
- **Unserved or Unreachable Market Segments.** Non-traditional outlets may allow a franchisor an opportunity to reach new customers who otherwise might be unreachable.
- **Brand Synergies.** Linking two brands (or co-branding) may allow both brands to benefit from the other brand's customers.
- **Expansion Vehicle for Franchisees.** Where franchisees in existing markets have little room to expand, non-traditional outlets may help satisfy their desire to grow.
- **Speed.** Non-traditional outlets often can be opened for business more quickly than traditional outlets.
- **Brand Awareness.** Non-traditional outlets in high-visibility locations can significantly increase a brand's public awareness.

Legal Issues in Non-Traditional Development

A franchisor who begins non-traditional development will need to consider a number of legal issues, including:

Encroachment. Claims that the franchisor's conduct impinged on a franchisee's territorial rights generally will turn on the specific contractual language of the existing franchise agreements. As a result, the starting point for a franchisor considering non-traditional development is to determine the restrictions imposed by existing

agreements.

An express reservation by the franchisor to distribute through a new channel of distribution will generally be respected by the courts. A few, mostly older cases, however, suggest that even if the existing franchisee does not have any exclusive territory, the implied covenant of good faith and fair dealing may restrict a franchisor's non-traditional development if the franchisor has not expressly reserved the right to expand its system.

State Law. Several state franchise relationship laws may impact a franchisor's ability to locate non-traditional outlets near existing franchisees. Specifically, the laws in Hawaii, Indiana, Iowa, Rhode Island, Washington and Wisconsin contain provisions that, to varying extents, prohibit a franchisor from competing with its franchisees.

Prior Representations. When considering non-traditional development, franchisors also should confirm that they have not made representations in disclosure documents or other written communications regarding new distribution methods. Even if these statements do not rise to the level of a commitment, they may impact the relationship with existing franchisees and hinder non-traditional development.

Price Discrimination. Price discrimination concerns need to be considered if the franchisor will sell goods to non-traditional outlets and to traditional outlets at different prices and if the non-traditional outlets compete with traditional outlets that buy the same goods. Differences in price may raise concerns under the federal Robinson-Patman Act and state antitrust laws.

Is the Proposed Non-Traditional Outlet a Franchise?

Non-traditional development will not avoid franchise registration and disclosure requirements simply because the operator is called a "licensee." However, just because a franchisor's traditional outlets are franchises does not mean that its non-traditional outlets will also be franchises. Whether the relationship is a franchise depends on whether it meets the three elements of the legal definition of a franchise:

- **Is a "franchise" fee charged?** What constitutes a franchise fee, however, is very broad and encompasses virtually all payments to the franchisor or its affiliates except for monies received for a reasonable quantity of inventory at a *bona fide* wholesale price.
- **Is there a "substantial association" with the franchisor's trademarks?** Although the registration states and the Federal Trade Commission (FTC) differ on the degree of association required, the franchisor may be able to argue that there is insufficient association with its trademarks or commercial symbols where only a branded product is added to an existing business.
- **Is there sufficient control or interdependence?** There are three alternative tests used for this element. First, the FTC uses the "significant control" or "significant assistance" test, which is applicable in the majority of the states. This test focuses on the franchisor's level of control or assistance over the franchisee's entire business. Second, under the "marketing plan" test, which is used by several states, a franchise exists when the franchisor prescribes a marketing plan, which the franchisee must follow. Third, under the "community of interest" test, which is used in a smaller number of states, a franchise exists when there is a sufficient level of interdependence between the franchisee and the franchisor.

Several types of relationships are excluded from franchise registration/disclosure requirements, even though they technically are franchises. Some examples of the exclusions that may be available for non-traditional development in certain instances are:

- **Fractional Franchises.** A fractional franchise generally is considered an addition to an existing business, in which the franchisee has at least two years of experience, that will be less than 20% of the franchisee's total business. These relationships are excluded by the FTC and California, Illinois, Indiana, Michigan, Minnesota, New York, South Dakota, Virginia and Wisconsin.
- **Sophisticated Franchisees.** A "sophisticated" franchisee generally must have a certain net worth or income, be required to invest a substantial amount of money in the franchise or have sufficient business experience. The FTC and California, Maryland, Rhode Island, Washington and Wisconsin exclude sales to "sophisticated" franchisees.
- **Existing Franchisees.** California, Hawaii, Maryland, Michigan, Minnesota, New York, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin exclude sales of additional franchises to existing franchisees.

Whether non-traditional development will be considered a franchise must be determined on a case-by-case basis. As franchisors consider the decision, they also should consider the ultimate scope of their non-traditional development. If a franchisor intends to engage in non-traditional development on a nationwide basis, it may not be feasible to structure the relationship to avoid franchise registration/disclosure requirements nationwide.

Franchising Services

Wiley Rein LLP represents franchisors on matters for which they require expert legal services. We can:

- Determine whether your business concept is a franchise. If it is a franchise, but you would prefer to avoid the registration/disclosure requirements, we can help you modify the business concept to avoid coverage by the franchise laws, if possible, or to take advantage of applicable exclusions.
- Work with you to develop franchise and related agreements that will permit the growth of your concept while allowing you to maintain control.
- Seek federal registrations for your trademarks and assist in maintaining and protecting those marks.
- Prepare the franchise disclosure document and provide guidance on how to use it.
- Prepare and file all franchise registrations, amendments and renewals, or seek exemptions from registration, in all applicable states.
- If you are a U.S. franchisor, assist you in taking your franchise concept abroad; if you are a foreign franchisor, assist you in bringing your franchise concept to the United States.
- Help you understand your contract rights and obligations and the statutory restrictions that apply to the franchise relationship (including transfers and contract renewals).

- Represent you in any proceedings brought by federal or state franchise regulators.
- Guide you in terminating the relationship with a franchisee without violating statutory restrictions.
- Represent you in litigation or arbitration proceedings with a franchisee.

For more information, please call Franchise Group Chair Bob Smith at 202.719.4481.

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