

Defining A Franchise

By Jay L. Welford and David L. Steinberg

Walk down most any street and chances are that one of the establishments you pass will be operating a franchised business. The industry has exploded - employing more than 18 million people and accounting for 40 percent of all retail sales - and it's not just fast food restaurants. As we recover from the great recession and the economy stabilizes, franchising has become an increasingly popular business expansion vehicle.

With this growth, and seemingly every type of product or service business now being franchised, it would appear that the creation of a system to sell franchises must be easy. In reality, nothing could be further from the truth, as franchising is regulated by both the Federal Trade Commission (FTC) Rule and individual state laws. With multiple governing bodies overseeing the development, growth and sales of franchises, there are multiple determinations of what a franchise actually is. These definitions are what validate the business and examining them is an integral step in developing a successful franchise operation.

The FTC Rule broadly defines the term "franchise" as a business format or a business opportunity. To qualify as a business format, a franchisee advertises and sells goods or services under the trademark, service mark trade name, or symbol. In the business format, a franchisor has significant control in the sale and marketing plan, and the franchisee is required to make a minimum \$500 payment to the franchisor within six months of opening. The less restrictive business opportunity venture exists when the franchisee sells goods or services supplied by the franchisor. In addition, the franchisor also secures the retail outlet and/or accounts. Similar to the business format, a minimum \$500 payment would be paid to the franchisor within six months before or after opening.

In Michigan, one must also be concerned with whether the business program will meet the definition of a "franchise" under the Michigan Franchise Investment Law (MFIL). This law also defines a franchise as a business licensed under a trademark or trade name. Similar to the FTC Rule, it requires franchisees to pay a fee directly or indirectly to the franchisor, and goods or services must be sold pursuant to a marketing plan.

Furthermore, if expanding into other states, there is another tangled web of individual franchise definitions and regulations.

Out of the 50 states, 16 regulate the offer and sale of franchises while another 24 regulate the offer and sale of business opportunities. Therefore, it is necessary to review each state's definition to determine in which category a business qualifies.

If all of the above criteria are met, a franchise company exists, and the franchisor must proceed with steps to create the franchise system. Once registered with the appropriate government agency, usually the attorney general's office, the franchisor is required to deliver a Franchise Disclosure Document (FDD) to the franchisee, prepared in accordance with the FTC Rule and MFIL, at least 14 calendar days before the purchaser pays any consideration or signs any agreement. The FDD is a lengthy, detailed document much like those prepared for private placements in the sale of securities.

This is just the tip of the iceberg. There are a myriad of other issues that must also be addressed, including restrictions on financial performance representations, advertising regulations, annual FDD updating and registration of franchise brokers. With all of these points and various definitions to consider, it is important to take time to understand your franchise and how various government agencies define your system. A clear interpretation provides a solid basis to decipher future regulations that will arise when building a successful franchise system.



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