SALES ARRANGEMENTS IN MOTION: RESELLER TO DISTRIBUTOR TO FRANCHISEE

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A. The Unregulated Distributorship Relationship

The seller-distributor relationship is largely unregulated in the United States. No single federal law governs this type of relationship, and the state laws are usually industry specific, focusing on termination only.

Where there are exceptions to this general rule, they tend to be in specific industries, such as alcoholic beverages, farm or heavy equipment, automobiles; and petroleum. These industries are regulated at the federal level (petroleum and automobiles), or by the individual states (alcoholic beverages, farm equipment, automobiles), or sometimes both.

The dearth of legislation or jurisprudence governing this issue means there is little meaningful advice to give a seller hoping to avoid the transformation of their casual reseller into a full-fledged distributor. The good news, however, is that there are few consequences to this transition. Except in the specific industries already mentioned and discussed in greater detail below, there are no special protections for distributors outside of traditional contract law remedies, such as those for breach or material alteration of a contract. The concept of goodwill indemnity, for instance, is virtually unheard of in the United States.

This means that the consequences of a reseller gradually metamorphasising into a distributor has far less impact in the United States that in Europe. The far greater risk, and the greater danger to the supplier, is a possible transition of the relationship with the reseller to that of a franchise, which is extensively regulated by statute and jurisprudence.

B. The Fuzzy Statutory Regulations

In those cases where the distributorship relationship is regulated, it is in the context of specific industries. Those statutes are rarely well-drafted, often using definitions of distributors, franchises, dealers or sales representatives that are inconsistent with the commercial realities, overbroad or just plain wrong. It makes it difficult to understand what relationship is being regulated.

1. Federal Regulation of Specific Industries

Federal law can regulate only those aspects of sales which have interstate impact: otherwise, this power is reserved to the states. Thus, there are only a few examples of federal regulations that govern distribution, and these exist in industries where, because of the interstate effect of the industry, federal regulation is needed. Two such examples are the Petroleum

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Marketing Practices Act and the Automobile Dealers' Day in Court Act[2], both of which show the definitional fuzziness described above.

The Petroleum Marketing Practices Act prohibits any "franchisor engaged in the sale, consignment, or distribution of motor fuel . . . [from] terminat[ing] any franchise . . . prior to the conclusion of the term, or the expiration date, stated in the franchise; or . . . fail[ing] to renew any franchise relationship[,]" for any reason except for one of the approved grounds for termination or nonrenewal specified in the act.[3]

A "franchise" is defined as a contract between a refiner and a distributor or retailer, or a distributor and another distributor or retailer, "under which a refiner or distributor (as the case may be) authorizes or permits a retailer or distributor to use, in connection with the sale, consignment, or distribution of motor fuel, a trademark which is owned or controlled by such refiner or by a refiner which supplies motor fuel to the distributor which authorizes or permits such use."[4] This definition could apply to many distribution relationships around the world.

Under the Act, the ability to terminate a franchisor relationship as defined in the Act is restricted to narrowly controlled circumstances. Termination requires notice according to a statutory timetable, and can only be based on the franchisee's failure to comply with a reasonable and material provision of the franchise, or to make a good faith effort to carry out the provisions of the agreement; an event relevant to the relationship which makes termination or nonrenewal of the franchise relationship; or a written agreement between the parties to terminate the franchise.[5] Nonrenewal, as distinguished from termination, may be based on the parties' failure to agree to good faith changes to the franchise agreement, bona fide customer complaints about the franchisee, the franchisee's failure to operate the marketing premises in an acceptable manner, or certain other conditions.[6]

The Automobile Dealers' Day in Court Act provides that "[a]n automobile dealer may bring suit against any automobile manufacturer . . . by reason of the failure of said automobile manufacturer . . . to act in good faith in performing or complying with any of the terms of provisions of the franchise, or in terminating, canceling, or not renewing the franchise with said dealer . . . ."[7] For the purposes of this act, an "automobile dealer" is "any person, partnership, corporation, association, or other form of business enterprise . . . operating under the terms of a franchise and engaged in the sale or distribution of passenger cars, trucks, or station wagons."[8] The act defines a "franchise" as a written contract between a manufacturer and a dealer that "purports to fix the legal rights and liabilities of the parties to such agreement or contract."[9] In this case, "good faith" is defined as "the duty of each party to any franchise, and all officers, employees, or agents thereof to act in a fair and equitable manner toward each other so as to

[2] 15 U.S.C. §§ 2801–07 (2012); 15 U.S.C. §§ 1221–26 (2012).
[3] 15 U.S. C. § 2802(a)–(b).
[4] 15 U.S.C. § 2801(1)(A).
[5] 15 U.S.C. § 2802(b). There is also a provision allowing certain franchisors to withdraw from marketing motor fuel. 15 U.S.C. § 2802(b)(2)(E).
[6] 15 U.S.C. § 2802(b)(2).
[7] 15 U.S.C. § 1222.
[8] 15 U.S.C. § 1221(c).
[9] 15 U.S.C. § 1221(b).

guarantee the one party freedom from coercion, intimidation, or threats of coercion or intimidation from the other party: *Provided,* That recommendation, endorsement, exposition, persuasion, urging or argument shall not be deemed to constitute a lack of good faith."[10]

Both acts contain a much broader definition of "franchise" than is typically seen in state or federal franchise statutes, and would cover most, if not all, distributors in these two industries. That said, both Acts also written require contracts. This fact, alone, makes it unlikely that a reseller in either industry would become a distributor inadvertently. The same goes for the supplier—they are unlikely to accidentally contract with a distributor and therefore be subject to the restrictions on termination and nonrenewal imposed by these two acts.

2. State Regulation of Specific Industries

State statutes governing distribution relationships in specific industries are generally focused on the termination, rather than the creation of such a relationship (although some states do have "front-end" or "registration/disclosure" regulations)[11], and may require compensation or just cause in order to terminate. Here, as with the federal law, the same definitional fuzziness prevails, with the terms "franchise", "wholesaler", "distributor" and "dealer" being used interchangeably and inconsistently across a variety of resale relationships.

Every state has a law governing the supplier-distributor relationship when it comes to beer, wine, liquor, or some combination of the three.[12] For example, Colorado's wholesaler termination statute prohibits a supplier from terminating an agreement with a wholesaler unless:

> (I) The wholesaler fails to comply with a provision of a written agreement between the wholesaler and the supplier;
> (II) The wholesaler receives written notification by certified mail, return receipt requested, from the supplier of the alleged noncompliance and is afforded no less than sixty days in which to cure such noncompliance;
> (III) The wholesaler fails to cure such noncompliance within the allotted sixty-day cure period; and
> (IV) The supplier provides written notice by certified mail, return receipt requested, to the wholesaler of such continued failure to comply with the agreement. The notification shall contain a statement of the intention of the supplier to terminate or not renew the agreement, the reasons for termination or nonrenewal, and the date the termination or nonrenewal shall take effect.[13]

New York requires that brewers sell and deliver beer to wholesalers only according to a written agreement, and states further:

[10] 15 U.S.C. § 1221(e).
[11] Thomas J. Goodwin, *The Inadvertent Franchise*, *Managing Legal Issues in Franchising* 2 (2013), *available at* 2013 WL 3773410.
[12] Beer, Wine, and Liquor Distributorships—Summary of Beer, Wine, and Liquor Statutes, 3 Franchise & Distrib. Law & Practice § 16:4 (2013).
[13] Colo. Rev. Stat. Ann. § 12-47-406.3(1) (West 2014).

> No brewer may cancel, fail to renew, or terminate an agreement unless the party intending such action has good cause for such cancellation, failure to renew, or termination and in any case in which prior notification is required under this section, the party intending to act has furnished said prior notification as provided . . . and the wholesaler has failed to cure such defaults or deficiencies after a period for cure . . . ."[14]

New York views only two scenarios as constituting "good cause": the first is "the implementation by a brewer of a national or regional policy of consolidation which is reasonable, nondiscriminatory and essential[,]" and the second is "a failure by the beer wholesaler to comply with a material term of an agreement . . . between the brewer and beer wholesaler."[15] These two situations carry additional requirements for the parties, but they are the only two basic instances in which termination or nonrenewal is allowed.

Many states also have statutes regulating distribution relationships in farm implements and heavy equipment.[16] For instance, a Kansas statute declares that:

> No farm equipment manufacturer, directly or through any officer, agent or employee may terminate, cancel, fail to renew or substantially change the competitive circumstances of a dealership agreement without good cause. For the purposes of this subsection, good cause means and includes the failure by a farm equipment dealer to substantially comply with essential and reasonable requirements imposed upon the dealer by the dealership agreement . . . .[17]

"Good cause" under the Kansas statute also includes: the dealer transferring an interest in the dealership; a change in the dealer's principal place of business without consent; or a failure on the part of the dealer to operate for seven consecutive days, to name a few.[18] Kansas does allow the dealership agreement to be either oral or written,[19] unlike the federal statutes and the state law examples which require a written contract.

The Maryland Fair Distributorship Act is the broadest of the industry-specific regulations. It regulates manufacturers and other persons who grant distribution and sales rights to a distributor, who sells "commercial goods". Alaska regulates the relationship of a distributorship and a dealer. In both cases, the focus is on the termination process, including repurchase of existing inventory.

3. Inadvertent Distributors?

[14] N.Y. Alco. Bev. Cont. § 55-c(3)–(4) (McKinney 2014).
[15] N.Y. Alco. Bev. Cont. § 55-c(2)(e).
[16] Summary of State Statutes on Farm Implements and Heavy Equipment, 3 Franchise & Distrib. Law & Practice § 16:6 (2013).
[17] Kan. Stat. Ann. § 16-1203 (West 2014).
[18] Kan. Stat. Ann. § 16-1203(a)–(h).
[19] Kan. Stat. Ann. § 16-1202(d). "'Dealership agreement' means an oral or written agreement of definite or indefinite duration between a farm equipment manufacturer and a farm equipment dealer which provides for the rights and obligations of the parties with respect to the purchase or sale of farm equipment." Id.

Realistically, under all of these state and federal laws in the regulated industries, a reseller is unlikely to become a distributor accidentally. Most of the federal and state statutes (although not all, as with Kansas, noted above) require a written contract for the creation of the regulated relationship. The distributor relationships, under whatever name they appear, do not arise inadvertently. Even in states that do not require a contract, the nature of the industries themselves minimizes the risk of an unintended relationship. Sellers of these types of goods are unlikely to be surprised to learn that they have a distributor for their goods.

It is, however, entirely possible for a reseller to become a distributor outside these regulated areas. The distribution relationship would arise from the "course of dealing" between the two parties, with the informal written or email interchanges, the payment process, and the normal sales structure defining the scope and terms of the relationship and of the sales transactions. Since the designation of a reseller as a "distributor" does not bring with it any negative consequences, there is often no reason to redefine or analyze the changing relationship.

C. The REAL Risk: Becoming a Franchise Relationship

1. Introduction

The real risk for a seller of products or services in the United States is not that their reseller will become a distributor, but that their reseller/distributor will be considered a franchisee. Both the federal government and the states regulate franchises, and the case law broadens the statutory definitions. Those definitions and judicial holdings often make it difficult to distinguish between a franchise and a distributorship. The consequences under U.S. law of accidentally becoming a franchisor are in most cases far more serious than moving from reseller to distributor.

The regulation of franchises in the U.S. takes two forms: pre-sale disclosure requirements and/or limitations on non-renewal or termination. The federal government has created a set of minimum disclosure standards in the Federal Trade Commission's Franchise Rule, which applies to all franchise sales. Approximately 15 states have built on this requirement, going beyond the federal requirement to more exacting notice, disclosure or registration standards. At the other end of the franchise life span, approximately half of the states have laws which place restrictions on when a franchise agreement may be terminated or non-renewed.[20] These states typically allow termination only for good cause, which "is frequently defined as a material breach of the franchise agreement[,]" not merely a "good faith business reason."[21] Some states impose both types of regulations.

The incentive to avoid becoming an unintended franchise is great, but avoiding a franchise may be easier said than done. Technically, as long as a seller and distributor do not meet the statutory requirements for a franchise in the state where they operate or have a place of business, they will not be inadvertently classified as a franchise. However, as an examination of the statutes and case law demonstrates, the statutes are often interpreted broadly and encompass practices that may not appear to meet the requirements of the franchise "test." Contractual

[20] Goodwin, supra note 10, at 2
[21] Id. at 6.

disclaimers or the intent of the parties in drafting their distribution agreements are routinely disregarded by courts, because of the public policy in favor of protecting franchisees.

2. The FTC Franchise Rule

Unlike distribution relationships, the federal government does regulate franchises. The "Franchise Rule," the Federal Trade Commission's regulation governing disclosure requirements, defines a franchise as having three essential components;

> *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.[22]

Note the express disclaimer in the introduction to the definition that the rule applies to any relationship which meets this definition "whatever it may be called".

The FTC Rule exempts from coverage any franchise where "the total of the required payments, or commitments to make a required payment, to the franchisor or an affiliate that are made any time from before to within six months after commencing operation of the franchisee's business is less than $540."[23] The Rule also exempts certain agreements between prior franchisees, where the level of revenue from the franchise will be less than 20% of the franchisee's income.

If the FTC Rule applies, then the franchisor must comply with a list of disclosure requirements to the franchisee before an agreement can be signed. The FTC does not give individuals a right of private enforcement of these regulations, but the FTC can impose other sanctions on the offending – and unsuspecting – franchisor, such as injunctive relief and hefty fines.

[22] 16 C.F.R. § 436.1 (2014).
[23] 16 C.F.R. § 436.8(a)(1) (2014).

3, State Statutes

a. Generally

Although state laws vary, there are two primary tests for determining whether a franchise exists, and they are similar in form to the FTC's Franchise Rule. Sellers must be aware of the franchise test adopted in the jurisdiction in which they intend to sell. A franchise relationship is defined by the characteristics of the relationship and the application of the appropriate test, not by the title the parties have given their relationship (even where parties have specifically stated that their arrangement is not a franchise)[24] or the belief of the parties as to what their relationship is.[25] Therefore, franchisors who affirmatively believe they have not entered such an agreement , or who have expressly disclaimed that status, may be surprised to find that their relationship meets all the requirements of a franchise and that they are, accordingly, vulnerable to legal action by discharged or dissatisfied franchisees.

Most commonly, state tests include two elements of the FTC test—1) use of, or association with, a trademark, and 2) payment of a franchise fee. State tests differ from the FTC test in the third element , which typically takes one of two forms. Some states, like California, require the use of a franchisor-prescribed "marketing plan." California's requirement, like the FTC's requirement, reads: "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 . . . ."[26] Other states, however, use a different requirement: like Nebraska, they look for a "community of interest" between the franchisor and franchisee:

> Franchise shall mean . . . a written agreement for a definite or indefinite period, in which a person grants to another person for a franchise fee a license to use a trade name, trademark, service mark, or related characteristics and in which there is a community of interest in the marketing of goods or services at wholesale or retail or by lease, agreement or otherwise . . .[27]

The "community of interest" version of this element provides a broader framework under which to find that a reseller or distributor relationship is, in fact, a franchise. Minnesota courts have gone so far as to hold that "the only condition necessary to establish a community of interest is the presence of fees derived from a common source."[28] Wisconsin uses a "totality of the circumstances" formula that takes

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[24] Oracle America, Inc. v. Innovative Technology Distributors, LLC, Nos. 11-CV-10143-LHK & 11-CV-02135-LHK, 2012 WL 4122813, at *1 (N.D.C.A. 2012) (finding a franchise where the agreement had stated that "'[n]either the General Terms not any Agreement is intended to create a . . . franchise . . . relationship[.]'").
[25] To-Am Equipment Co., Inc. v. Mitsubishi Caterpillar Forklift America, Inc., 152 F.3d 658, 666 (7th Cir. 1998).
[26] Cal. Corp. Code § 31005(a).
[27] Neb. Rev. St. §87-402(1),
[28] James R. Sims, III & Mary Beth Trice, The Inadvertent Franchise and How to Safeguard Against It, 18 Franchise L.J. 54, 57 (1998).

into account "the franchisor's continuing financial interest and the interdependence of the contracting parties."[29]

Like the FTC, states may also have minimum franchise fee thresholds. Illinois, Rhode Island, and Virginia all require a minimum $500 franchise fee in order to meet the test for a franchise.[30] Other states have a required fee as one of the elements of the franchise test, but do not specify a minimum amount.

b. New Jersey and New York—Two Exceptions to the General Franchise Framework

New Jersey presents an example of a state that diverges from the two typical models. The New Jersey Franchise Practices Act requires only two of the traditional elements to establish a franchise: the license element, and a community of interest.[31] New Jersey does not require the payment of a franchise fee,[32] and as a result, more agreements may potentially be inadvertently characterized as franchises under New Jersey law. Although the New Jersey law also requires that the franchise agreement "contemplate or require the franchisee to establish or maintain a place of business within the State of New Jersey," the United States District Court for the District of New Jersey held that to satisfy the "contemplation" requirement, the franchise need only "'reasonably anticipate that the franchisee would establish a New Jersey place of business.'"[33] This interpretation would potentially capture relationships that only "reasonably anticipate" a New Jersey place of business.

New York also takes a somewhat nonconventional approach to defining a franchise. Under the General Business Law, a franchise will be found to exist if the franchisee is required to pay a franchise fee ("directly or indirectly"), and one of the two following conditions is met: (1) the franchisee operates under a "marketing plan or system prescribed in substantial part by a franchisor" or (2) the goods or services are "substantially associated with the franchisor's trademark . . . ."[34] Requiring only two of the three traditional elements likely has the effect of capturing more potential franchise relationships than the stricter three-prong test.

4. Case Law

The following cases represent some of the surprisingly broad constructions given to state franchise laws. These cases serve as a warning to suppliers that compliance with the franchise

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[29] Id. at 56.
[30] 815 Ill. Comp. Stat. Ann. 705/3(1)(c) (West 2014); R.I. Gen. Laws. Ann. § 19-28.1-3(7)(i)(B) (West 2014); Va. Code Ann. §13.1-559(A)(3) (West 2014).
[31] N.J. Stat. Ann. §56:10-3(a) (West 2014).
[32] Id.
[33] Strassle v. Bimbo Foods Bakeries Distrib., Inc., No. 12-3313, 2013 WL 1007289, *4 (D.N.J. 2013) (quoting Instructional Systems, Inc. v. Computer Curriculum Corp., 614 A.2d 124, 136 (N.J. 1992)). The New Jersey law additionally requires that the "gross sales of products or services between the franchisor and franchisee . . . shall have exceeded $35,000.00 for the 12 months next preceding the institution of suit pursuant to this act, and . . .more than 20% of the franchisee's gross sales are intended to be or are derived from such franchise . . . ." N.J. Stat. Ann. § 56:10-4(a)(2)–(3) (West 2014).
[34] N.Y. Gen. Bus. Law § 681(3)(a)–(b) (McKinney 2014).

requirements may be unavoidable, even when the parties are familiar with the requirements of their jurisdiction's franchise law and take affirmative steps to avoid classification as a franchise.

a. *Generally*: Gentis v. Safeguard Business Systems, Inc.

Safeguard manufactured and sold record-keeping systems and office products.[35] The plaintiffs, Safeguard's distributors, solicited orders, installed systems, pursued leads and referrals, and maintained relationships with customers.[36] Despite their designation as distributors, the distributors were in many respects more like commercial agents: they were not authorized to "enter into binding sales contracts; did not maintain any inventory; did not pass title to products; did not bill customers; and did not ordinarily deliver goods to customers."[37] They did, however, on occasion distribute goods, guarantee customer payments, and set prices on certain items.[38] Because of these activities, the distributors were found to be franchisees under California law.[39]

b. *Licensing Requirement*: Instructional Systems, Inc. v. Computer Curriculum Corp.

According to the terms of the agreement between Instructional Systems, Inc. (ISI) and Computer Curriculum Corp. (CCC), ISI was an exclusive distributor of CCC products and was required to "use its best efforts to maintain and promote CCC's name, trademark and logo on the Products. ISI is authorized, so long as this Agreement is in effect . . . to use CCC's name, trademark and logo in its advertising, exhibits, trade shows, public relations materials and manuals as the same relate to the Products."[40]

However, despite these requirements, ISI "always operated under its own trade name, and admits that it [did] not use CCC's name on its stationery, business cards, or on any business signs…"[41]

Although CCC characterized the rights granted under the agreement as "limited," based on the exclusive nature of the distribution and the requirement that ISI "maintain and promote CC's name . . .[,]" the Supreme Court of New Jersey found that the trademark was used "in such a manner as to create a reasonable belief on the part of the consuming public that there is a connection between the trade name licensor and licensee by which the licensor vouches, as it were, for the activity of the licensee in respect of the subject of trade name."[42] Therefore, CCC did grant ISI a license to use the ISI trademark.[43]

c. *Franchise Fee*: To-Am Equipment Co., Inc. v. Mitsubishi Caterpillar Forklift America, Inc.

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[35] Gentis v. Safeguard Business Systems, 60 Cal. App. 4th 1294, 1297 (Cal. App. 2 Dist. 1998).
[36] Id. at 1301.
[37] Id. at 1303.
[38] Id. at 1305.
[39] Id.
[40] Instructional Systems, Inc. v. Computer Curriculum Corp., 614 A.2d 124, 139 (N.J. 1992).
[41] Id. at 139.
[42] Id.
[43] Id. at 140.

This case quantifies the possible financial impact of seemingly innocuous activities, leading to classification as a franchise. This case involved a jury award for $1,525,000, based on the testimony of two economic experts, which was upheld on appeal by the 7th Circuit.

The To-Am decision begins inauspiciously: "Legal terms often have specialized meanings that can surprise even a sophisticated party. The term 'franchise,' or its derivative 'franchisee,' is one of those words."[44]

To-Am had a dealership agreement with a Mitsubishi affiliate to sell forklifts.[45] The agreement required, in part, that To-Am maintain sales and service manuals.[46] One set was originally provided free of charge, but additional sets were needed.[47] Over time, the manuals cost To-Am over $1,600.[48] The agreement did not explicitly require franchise fee payments, but did require that To-Am maintain a supply of the manuals.[49]

The 7th Circuit held that, in light of the broad language of the Illinois franchise regulations and the legislative intent that a "wide class of dealers, distributors, and other 'franchisees'" be protected, the purchase of required manuals constituted a franchise fee.[50] The Mitsubishi affiliate therefore had terminated the franchise without good cause, as required by the Illinois franchise law, and it failed to repurchase Tor-Am's inventory following termination.

d. *Community of Interest*: Engines, Inc v. MAN Engines

Engines, Inc. was a seller of marine engines and an authorized dealer for MAN Engines & Components.[51] Engines moved to a new location and a larger facility to accommodate MAN's business, but would not be able to utilize the facilities if the relationship with MAN ended.[52] Engines also maintained that it was dependent upon MAN, and would be forced out of business if its relationship with MAN was terminated.[53]

The court in Engines, Inc. found this dependence to be the basis for a finding of a "community of interest." The court held that "franchise-specific investments" and "'indicia of control' of [the] franchisor over [the] franchisee" characterize a community of interest.[54] Citing tangible and intangible property that Engines stood to lose if the agreement was terminated, and the inequality of bargaining power between the two parties, the court held that the "community

[44] To-Am Equipment Co., Inc. v. Mitsubishi Caterpillar Forklift America, Inc., 152 F.3d 658, 659–60 (7th Cir. 1998).
[45] Id. at 660.
[46] Id.
[47] Id.
[48] Id.
[49] Id. at 662–63.
[50] Id. at 661–62, 664.
[51] Engines, Inc. v. MAN Engines & Components, Inc., No. 10-277 (RMB/KMW), 2010 WL 3021871, *1 (D.N.J. 2010).
[52] Id. at *4.
[53] Id. at *5.
[54] Id. at *6.

of interest" element was satisfied, as were the other elements, and granted a preliminary injunction.[55]

[55] Id. at *6–7, *11.

e. *Marketing Plan*: Blankenship v. Dialist International Corp.

Blankenship represented Dialist products under a distribution agreement.[56] Blankenship received "a detailed explanation of the Dialist system and instruction on how to market the product" and a binder of promotional materials, but was never given additional instruction as promised.[57] According to the distribution agreement, Blankenship could "'develop his territory and sales staff without interference.'"[58] However, the court found that the mandatory use of a marketing plan was not necessary for a franchise to exist. Rather, the "marketing plan" requirement focuses on "whether such a right was provided under the contract."[59] The Appellate Court of Illinois held that, based on the materials and instruction Blankenship received, "the statutory requirement of the existence of a marketing plan or system" was satisfied.[60]

D. Implications for the Supplier

De facto franchisors can be subject to a variety of sanctions for failure to register and disclose information, or violating the franchise termination rules. These penalties can include rescission, attorney's fees, and damages and in some cases, treble damages. Under California's rules corporate officers and directors could be personally liable and subject to criminal sanctions.

As a reseller moves from a simple reseller to a distributor, most often by an implied contract arising out of a course of dealing, a supplier is confronted with how to avoid that reseller becoming a franchisee of the supplier.

1. Is Inadvertent Franchising Avoidable?

Instructions for avoiding an inadvertent franchise are simple to give, but difficult to follow. In theory, to avoid becoming a franchisor, a supplier must familiarize themself with the franchise "test" in the states in which the distributor is operating, and take steps to ensure that they fail to meet at least one of the elements. However, as already discussed, in many states the elements have been interpreted very broadly. The simple act of not charging a distributor something called a "franchise fee" does not mean that a supplier and distributor will not meet the definition of a franchise: some other payment from the distributor to the supplier might be

[56] Blankenship v. Dialist International Corp., 568 N.E.2d 503, 505 (Ill. Ct. App. 5th Dist. 1991).
[57] Id. at 505.
[58] Id. at 506.
[59] Id.
[60] Id. at 507.

interpreted as a franchise fee regardless of its title or purpose. Moreover, some states do not require a franchise fee at all in order to find a franchise relationship.

One commentator notes the difficulty in avoiding any of the traditional elements of a franchise, and suggests that parties "achieve compliance with the strictest jurisdiction in which the manufacturer and distributor conducts or intends to conduct business."[61] Others suggest that "a purely commission-based agency/principal relationship between a seller of goods or services and its sales force, where the agents make no payments for training, brochures, or other items or services to the seller" might be a way to avoid franchising, since there are no required payments.[62] However, this approach appears to ignore the reasons why a supplier would choose a distributor rather than a sales agent in a particular market. It also does not eliminate the possibility that a court might find a "hidden franchise fee" somewhere in the arrangement.[63]

2. Precautionary Steps for the Supplier

There are steps a supplier could take to attempt to minimize the impact of a "franchise" classification. Anything other than full compliance with the state and federal laws risks sanctions, but businesses often make calculated cost vs. risk decisions in structuring business relationships.

- Comply with the FTC Rule and state disclosure laws vis-á-vis a reseller who is moving towards a distributor-type relationship with the supplier. That eliminates one source of possible damages and enforcement action.

- Look at any industry-specific regulatory statutes in advance of sales in the U.S.: budget for inventory buy-backs, and be aware of notice requirements. Don't give the distributor a cause of action by violating the law's requirements.

- Base distributors in states with the lowest levels of franchise regulation

- .Assume that all terminations will have to be negotiated, unless there is "good cause" for the termination: plan for the financial outlay if termination starts to look necessary.

- Try to comply with the franchise law termination requirements as much as possible, particularly the notice requirements, even if you believe you don't have a "franchise".

[61] Goodwin, supra note 10, at 7.
[62] Sims & Trice, supra note 27, at 58.
[63] Id.

- ***Surrender***: realize that you have a "franchise" whether you like it or not, and comply with the federal and state laws on disclosure and termination where you are selling.

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