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ANALYSIS

Avoiding the 'accidental franchise'

Companies liable if actions or relationships trigger franchise laws

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Recent court rulings in Connecticut underscore the need for companies to examine whether their relationships with distributors or sales representatives may be regulated under franchise laws before taking actions, such as termination, to alter those relationships.

In December 2004, a Connecticut jury in a federal court awarded a terminated insurance sales agent \$2.3 million in damages for wrongful termination, finding that the relationship was a "franchise." More recently, the Connecticut Supreme Court in March decided a case in which a party acting as both a distributor and a sale representative sought damages and to stop the termination of the agreements, arguing it was essentially a franchisee. The court ultimately determined that the relationships were not franchises — and even if they were, there was good cause to terminate — but not before costly litigation had ensued.

Given the legal scrutiny and potential litigation costs and damages, companies should make sure their actions and relationships have not created so-called "hidden franchises," restricting their rights to terminate agreements without cause, even if permitted under the agreement. All distribution relationships, even long-standing arrangements, must be reviewed with an eye towards the recent court interpretations of what constitutes a franchise.

Connecticut, along with 16 other states, regulates the termination of franchise relationships to protect the franchisee. Some states regulate other aspects of the franchise relationship. Under the Connecticut Franchise Act, three elements are needed to establish a

franchise. The first two elements are related: the sale or distribution of goods and services that are substantially associated with the manufacturer's trademark.

These are usually easy to establish, though there have been Connecticut cases that found sales representatives don't "sell" and are not franchisees because they don't have title to the goods, don't bear the credit risk for non-payment, and their financial risk



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is limited to their commission. This distinction between sales representatives and distributors was not discussed in these two recent cases.

Most cases depend on whether the third element is present: a marketing plan prescribed in large part by the franchisor. The Connecticut Supreme Court describes this third element as the extent of control exerted by the manufacturer over the sales representative or distributor. Control over the hours and days of operation, inventory levels, advertising, lighting, employee uniforms, prices, hiring of staff, sales quotas and management training and the right to audit books and records or inspect the business premises are factors that have been examined in different cases. The court described control over pricing as the most significant factor.

Under the Connecticut Franchise Act,

if a franchise relationship exists, then terminating a distributor or sales agent requires good cause and a minimum 60-days' notice or the company risks a wrongful termination claim. The company also has an obligation to purchase the franchisee's inventory, equipment and supplies.

Determining whether the company has "good cause" to terminate requires review before sending the termination notice. When it is not clear the relationship is a franchise, complying with the statutory requirements by terminating only for good cause and giving at least 60 days' notice of termination will position the company to better defend any wrongful termination action.

Determining whether distribution agreements are "hidden franchises" is also important under federal and state franchise disclosure and registration laws. The Federal Trade Commission Franchise Rule and the laws of 15 states require presale disclosure concerning the franchise offering in a prescribed form. Registration is also required in 14 of these states. State business opportunity laws which require disclosure and/or registration may also apply.

The elements of a "franchise" for registration and disclosure laws are an association with the franchisor's trademark, significant control or assistance provided by the franchisor (under state law this is expressed as providing a marketing plan or the parties having a community of interest) and a fee paid to the franchisor or its affiliates. Distributors and sales representatives don't usually pay fees, but hidden costs for items such as training, manuals, equipment or software can be viewed as fees. ■

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