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The Exception Becomes the Storm: *Insurance Sales Agents as Franchisees*

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Insurance companies are large businesses, accustomed to state licensing requirements and regulation and known to state regulators and federal authorities. For 35 years, neither the states nor the Federal Trade Commission have sought compliance by insurance companies with state franchise laws or the Federal Trade Commission Franchise Rule.

The interpretative guides to the FTC rule provide that sales agents are not franchisees, specifically referencing insurance sales agents: "Agency relationships in which independent agents, compensated by commission, sell goods or services (e.g. insurance salespersons) are excluded, since there is no 'required payment.'"

A storm has been slowly developing targeting the insurance sales agent relationship, threatening to establish a franchise exists. If successful, insurance companies would have to comply with federal and state disclosure requirements and state registration requirements and adhere to state franchise relationship laws that commonly govern termination and renewal, and impose a duty of good faith and fair dealing. The biggest exposure is retroactive application of franchise laws to the sales agent relationship, resulting in fines and damages for acting in accordance with long-standing industry practices.

Sales agents had unsuccessfully invoked the protections of franchise laws in nine cases. But in December 2004, a Connecticut jury in the federal district court case of *Charts v. Nationwide Mutual Insurance Co.*,

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et al., found, for the first time, that an insurance sales agent was a franchisee. The jury awarded \$2.3 million in compensatory damages for termination without good cause in violation of the Connecticut Franchise Act and the Connecticut Unfair Trade Practices Act.

In *National Association of State Farm Agents Inc. v. State Farm Mutual Automobile Insurance Company, et al.*, pending in the District of Columbia Superior Court, an association of State Farm captive sales agents is alleging that several of the company's business practices violate franchise laws of 15 states and by extension, the FTC rule, but the Connecticut Franchise Act is not included.

The sales representative relationship poses the risk, usually considered low, of the "unintentional" or "hidden" franchise. The FTC rule defines a "franchise" as: The offer, sale or distribution of goods or services by the franchisee; identification with the franchisor's trademark; significant control over the franchisee's method of operation or significant assistance to the franchisee; and required payments of at least \$500 before or within six months after commencing operations.

State law definitions of a franchise vary, but they are similar to the FTC rule definition, substituting the element of a marketing plan or system prescribed by the franchisor, or a community of interest, for the significant control or assistance element. A franchise fee is not required under some state

relationship statutes. The absence of the fee element in Connecticut made it easier for the jury in *Charts* to find a franchise existed. Sales representative relationships may also constitute a business opportunity under state business opportunity laws due to the marketing program element. However, an exemption would usually be available for insurance companies.

The interpretative guides to the FTC rule cite the absence of a fee as the reason sales agents are not considered franchisees. The insurance sales agents' association in *National Association of State Farm Agents Inc.* asserts a number of fees paid by agents, including the costs of a bank account, signs, computers, cooperative advertising payments, sales brochures and promotional items. The issue of what constitutes a franchise fee is often critical in unintended franchise cases. In *To-Am Equipment Co. Inc. v. Mitsubishi Caterpillar Forklift America Inc.*, decided by the 7th U.S. Circuit Court of Appeals in 1998, the court held that the aggregate cost of purchases of parts and service manuals totaling \$1,659 over nine years was sufficient under the Illinois Franchise Disclosure Act, which had no time limit, to reach the \$500 fee threshold.

Compare the 2003 decision by the U.S. District Court for the Central District of California in *Adees Corp. v. Avis Rent-A-Car System Inc.*, interpreting the California Franchise Relations Act. The court used a less restrictive test, citing three factors: whether the party making the payment received something of value in exchange; whether the payment was an ordinary business expense or an unrecoverable investment; and whether the party making the

payment put its own money at risk. The court found that a fleet surcharge and a refueling charge, withheld from commission payments, did not constitute franchise fees.

The absence of a fee is not the only basis for excluding sales representatives from coverage of the franchise laws. The sales representative relationship provides a unique opportunity to focus on the element of offering, selling or distributing goods or services by the franchisee.

In 1998, the California Court of Appeal created a stir by its decision in *Gentis v. Safeguard Business Systems Inc.*, finding coverage under the California statute. The court described the sales representatives as more than sales representatives, but their activities do not seem unusual: soliciting orders, demonstrating products, solving customer problems, installation, continued customer contact, generating new business and ongoing service. They also on occasion took delivery of the goods, guaranteed customer payment and set prices on certain products.

The court distinguished a line of cases from other jurisdictions that held sales representatives did not “sell” because they could not enter into binding contracts, did not maintain inventory, pass title or bill, or deliver goods. The court focused on the inclusion of the ability to “offer” goods under the California statute, not present in the other state laws. The court had to disagree with cases from other jurisdictions, including

George R. Darche Associates v. Beatrice Foods Co., decided by the U.S. District Court for New Jersey and affirmed by the 3rd Circuit, interpreting Connecticut law, which held that sales representatives did not “offer” goods because the acceptance of an offer would result in a contract which the sales representative did not have the authority to make.

The jury verdict in *Charts* appears contrary to the Connecticut cases, which hold that a sales representative is not a franchisee because the sales representative does not offer, sell or distribute goods. After *Gentis*, the Connecticut Supreme Court in 2000 in *Getty Petroleum Marketing Inc. v. Ahmad* and the 2nd Circuit in 2002 in *Rudel Machinery Company Inc. v. Giddings & Lewis Inc.*, determined that a sales representative is not selling because it does not have title to the goods; it is not exposed to the credit risk if the customer does not pay; and financial risk only depends on the amount of the commission based on the amount of orders.

More than half the states have adopted laws for the protection of sales agents, requiring payment of commissions following termination of the agreement. While it is not totally inconsistent to provide this protection and also apply franchise laws, the double layer of regulation of the same termination event with different aims suggests the legislatures didn’t consider sales agents to be franchisees, and any

coverage under the franchise laws would be unintended. The three-part test applied in the Connecticut courts and elsewhere highlights the lower level of investment made by sales agents as the primary reason for the different treatment.

If insurance sales representatives are held to be franchisees, the decision will affect captive agents more than independent agents. The FTC rule contains an exemption for fractional franchises where the franchisee or any of its current executive officers or directors have been in the business for more than two years and the parties anticipate that sales arising from the relationship will represent no more than 20 percent of sales in dollar volume in the first year. Some states have similar or additional exemptions that may apply, however the state exemptions, including the fractional franchise exemption, are often only an exemption from registration with the state and do not eliminate the disclosure obligation.

It will take several more years until the impact of the *Charts* and *National Association of State Farm Agents Inc.* cases will be known, assuming appeals will be taken from the initial decisions. The cases point out the potential wide coverage of franchise laws and the very real problem of the “unintentional” or “hidden” franchise, in this case insurance industry giants, selling as they have for many years, hiding in plain sight. •