

General Contract Clauses: No Franchise

MATTHEW J. KREUTZER, HOWARD & HOWARD PLLC, WITH PRACTICAL LAW COMMERCIAL

This Standard Clause memorializes the parties' intent to form a commercial agreement that will not fall within the legal definition of a franchise under US federal or state franchise laws. Parties (typically, sellers or suppliers) often include this Standard Clause in their licensing, goods or services agreement. This Standard Clause has integrated notes with important explanations and drafting and negotiating tips.

DRAFTING NOTE

Read This Before Using Document

Unless the parties intend to enter into a franchise agreement, parties (in most cases, sellers) often seek to avoid the impact of US federal or state franchise laws, including state dealer protection statutes. By including these Standard Clauses, the parties demonstrate to each other, courts and other third parties their intent to form a commercial agreement that is excluded from franchise requirements regarding:

- Disclosure and registration.
- Relationship, renewal and repurchase obligations.
- Limitations on termination rights.

Enforceability

Although these Clauses can effectively demonstrate the parties' intent, they do not

completely prevent a court from deeming the agreement to be a franchise agreement.

Franchise laws vary from state to state, so before finalizing their agreement, parties should understand whether and how these laws apply to and classify the agreement. However, despite state law differences, courts typically look beyond the agreement's words to the facts of the transaction to determine whether a franchise exists. For example, even if a sale of goods agreement includes these Standard Clauses, a court is more likely to deem the transaction to be a franchise if:

- The buyer has the right to use the seller's trademark, service mark, trade name, logo or other commercial symbol of the seller.
- The seller either:
 - retains significant control over the



- manner and method of operation of the business;
 - provides significant assistance to the buyer's business operations; or
 - prescribes a marketing plan or system that the buyer must follow.
- The buyer pays at least \$540 to the seller either before or during the first six months of the operation of the business.

Franchise Defined

A franchise is a license under which the seller (franchisor) grants to an individual or entity (franchisee) the right to market and sell the franchisor's goods or services using the franchisor's trademark and other intellectual property in exchange for a franchise fee paid by the franchisee. In granting that license, a franchisor typically exercises substantial control over the franchisee's business. What constitutes a franchise can depend on the definitions under federal or state law. For more information on franchising, see *Practice Notes, The Franchise Rule and its Disclosure Requirements* (<http://us.practicallaw.com/3-524-1564>) and *Distributors and Dealers: Federal Law* (<http://us.practicallaw.com/8-500-4225#a380871>) and *Article, Franchising country questions: US* (<http://us.practicallaw.com/2-102-2118>).

Franchise as Distinguished from Business Opportunity

A business opportunity agreement is a type of distribution agreement that does not necessarily create an agency relationship. Under a typical business opportunity arrangement, the buyer obtains the right to offer, sell or distribute goods or services under these conditions:

- The goods or services are supplied by:
 - the seller;
 - seller's affiliate; or
 - a third person with whom the buyer must or is advised by the seller to do business with.
- The buyer must pay the seller or seller's affiliate as a condition of obtaining or commencing operation of the business opportunity (either by contract or by practical necessity). This does not include payments for the purchase or reasonable amounts of inventory at bona fide wholesale prices for resale or lease.
- One or more of the following is true:
 - the seller agrees to provide the buyer with retail outlets or accounts or assistance in establishing retail outlets or accounts (including internet outlets) for the sale or distribution of the goods or services;
 - the seller agrees to provide the buyer with locations or assistance in finding locations for vending machines, electronic games, rack displays or any other equipment or display for use in the sale or distribution of the goods or services that is leased, controlled or paid for by the purchaser;
 - the seller represents and warrants that there is a market for the goods or services and the buyer can earn a profit in excess of the initial payment; or
 - the seller represents that it will buy back any or all of the goods or services that the purchaser makes, produces, fabricates, grows, breeds, modifies or provides.

Work-at-home opportunities, such as envelope stuffing, product assembly and medical billing, are often considered business opportunity arrangements.

Although franchise and business opportunity agreements have similar attributes, these transactions have different costs and risks. For example:

- State business opportunity laws typically vary more widely than franchise laws. As a result, parties likely can more successfully use contract language to avoid franchise laws in all states than avoid business opportunity laws in all states.
- Business opportunities typically require the parties to make lower set-up and operating investments than franchises.

For more information on business opportunities, see *Article, Franchising country questions: US* (<http://us.practicallaw.com/2-102-2118>).

Assumptions Used in these Standard Clauses

These Standard Clauses assume that:

- **The agreement does not implicate any state franchising laws.** The applicable definition of "franchise" may vary depending on the laws applicable to the parties or the transaction.
- **The parties to the agreement are US entities and the goods or services are provided in the US.** If any party is organized or operates in or the goods or services are to be used or delivered in a foreign jurisdiction, these terms may need to be modified to comply with applicable laws in the relevant foreign jurisdiction.
- **These terms are not industry-specific.** These provisions do not account for any industry-specific market practices or federal or state laws, rules or regulations that may apply to the particular transaction.

- **These terms are being used in a business-to-business transaction.**

These provisions should not be used for providing goods or services to individual consumers, which may involve legal and regulatory requirements and practical considerations that are beyond the scope of this resource.

- **Capitalized terms are defined elsewhere in the agreement.** Certain terms are capitalized but not defined in these Standard Clauses because they are defined elsewhere in the agreement (for example, Agreement, Notice, Parties and Seller).

Bracketed Items

Bracketed items in ALL CAPS, if any, should be completed with the facts of the transaction. Bracketed items in sentence case are either optional provisions or include alternative language choices, to be selected, added or deleted at the drafting party's discretion.

1. No Franchise Agreement.

DRAFTING NOTE

No Franchise Agreement

These Standard Clauses do not completely prevent a court from deeming the agreement to be either a franchise agreement. Therefore, the parties should:

- Structure the transaction and draft the operative provisions so that a court

is unlikely to deem the transaction a franchise agreement.

- Include a mitigation procedure that the parties must follow if the agreement is deemed a franchise agreement (see *Drafting Note, Mitigation Procedure*).

The parties to this Agreement are independent contractors and nothing in this Agreement shall be deemed or constructed as creating a joint venture, partnership, agency relationship or franchise between [Seller/Supplier] and [Buyer/Customer/Distributor/Reseller]. Neither party, by virtue of this Agreement, will have any right, power or authority to act or create an obligation, express or implied, on behalf of the other party. Each party assumes responsibility for the actions of their personnel under this Agreement and will be solely responsible for their supervision, daily direction and control, wage rates, withholding income taxes, disability benefits, or the manner and means through which the work under this Agreement will be accomplished. Except as provided otherwise in this Agreement, [Buyer/Customer/Distributor/Reseller] has the sole discretion to determine [Buyer/Customer/Distributor/Reseller]'s methods of operation, [Buyer/

Customer/Distributor/Reseller]'s accounting practices, the types and amounts of insurance [Buyer/Customer/Distributor/Reseller] carries, [Buyer/Customer/Distributor/Reseller]'s personnel practices, [Buyer/Customer/Distributor/Reseller]'s advertising and promotion, [Buyer/Customer/Distributor/Reseller]'s customers, and [Buyer/Customer/Distributor/Reseller]'s service areas and methods. The relationship created hereby between the parties is solely that of [Seller/Supplier] and [Buyer/Customer/Distributor/Reseller]. If any provision of this Agreement is deemed to create a franchise relationship between the parties, then [Seller/Supplier] may [immediately/ on [NUMBER] day's written Notice] terminate this Agreement/the parties shall negotiate in good faith to modify this Agreement so as to effect the parties' original intent as closely as possible in a mutually acceptable manner in order that the transactions contemplated hereby be consummated as a [TYPE OF AGREEMENT] agreement and not a franchise agreement].

DRAFTING NOTE

Independent Contractors

This Clause contains an independent contractor provision to help ensure that the parties and third parties (including courts) treat the relationship under the agreement as an independent contractor relationship. Generally an individual is an independent contractor if the individual's client controls only the result of the individual's work and not the means and method by which the work is accomplished. By using this Clause, the parties disclaim control (a key element of franchising) and therefore likely avoid many of the financial and other franchising obligations (see *Drafting Note, Enforceability*).

When using these Standard Clauses, the parties should ensure that the agreement contains no other conflicting independent contractor provisions.

Mitigation Procedure

In the last sentence of this provision, the parties must negotiate whether, if the agreement is deemed to create a franchise relationship, either:

- The seller may terminate the agreement. The parties are likely to elect to include this option if the seller:
 - is the party most likely to be negatively impacted if the agreement were to be deemed a franchise agreement; or
 - has the requisite bargaining power.
- The parties must modify the agreement to effect the parties' original intent that the agreement is a non-franchise agreement. This approach is more balanced but also more likely to lead to disagreement because the parties may not quickly or easily modify the agreement.

In neither case does termination or contract modification address past or existing liability from the contract having been deemed a franchising agreement. Therefore, it is important for parties to structure the transaction and draft the operative provisions to reduce the likelihood that a court will deem the transaction a franchise agreement.

ABOUT PRACTICAL LAW

Practical Law provides legal know-how that gives lawyers a better starting point. Our expert team of attorney editors creates and maintains thousands of up-to-date, practical resources across all major practice areas. We go beyond primary law and traditional legal research to give you the resources needed to practice more efficiently, improve client service and add more value.

If you are not currently a subscriber, we invite you to take a trial of our online services at us.practicallaw.com. For more information or to schedule training, call **888.529.6397** or e-mail ustraining@practicallaw.com.

For the links to the documents referenced in this document, please visit our online version at us.practicallaw.com/4-547-8725