

Practice Guides

# FRANCHISE

Fifth edition

Contributing editor

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LEXOLOGY

Getting the Deal Through



# Preface

## Philip F Zeidman<sup>1</sup>

In my introduction to a sister volume, *Lexology Getting The Deal Through: Franchise*, I described an experience many of us have had. I recounted how a general counsel arrived at the office to find a message from his boss, posing a series of questions about franchising in a number of countries around the world — questions to which the general counsel, understandably, has no ready answers. The same experience, of course, is familiar to outside counsel encountering a client's expectations.

A survey of the available sources of information comes up empty. None is sufficiently comprehensive yet digestible. *Lexology Getting The Deal Through: Franchise* seeks to meet that need by posing and answering the key questions one must address about franchising in a country. Now in its 17th edition, it covers 21 countries and has proven its value many times over. It is a classic 'desk book' that belongs next to your telephone or your computer.

But what then? After your response — rapid and impressive, no doubt — what happens when you need to delve more deeply into the issues raised by your

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company's or client's plan to expand by franchising? For that purpose, a book that provides answers to threshold questions, however succinct and authoritative, is, as social scientists say, 'indispensable but insufficient'. By now you know that franchising touches, glancingly or with full force, on almost every legal discipline. And you also know that none of those disciplines addresses franchising as squarely as you would like; that there are shockingly few law schools that include franchising in their curriculum; and that there are no course books that adequately cover the territory you will need to traverse.

Enter *Lexology Getting The Deal Through's Practice Guide: Franchise*. If *Lexology Getting The Deal Through: Franchise* was designed to be left on your desk, *Practice Guide: Franchise* can perhaps best be thought of as the book you will take on your next flight.

So settle in.

*Please adjust your seat, your footrest and your reading light.*

You will almost certainly want to begin by examining the fundamental legal doctrines, statutes and regulations that govern how franchising is treated in law. That obviously requires an understanding of how different countries have chosen to regulate franchising explicitly (or declined to do so). So you begin with 'Global Overview of Specific Franchise Statutes and Regulations', which includes a handy chart at the end, keyed to the various approaches.

But you will also want to step back and examine older and broader legal constructs, to understand how franchising is treated in the foundational legal structures of different countries. In 'Common Law and Civil Law on Franchising Issues', you will get a sense of the circumstances in which analyses of those two systems may lead to different results.

It is essential to recognise that the limitations on a franchisor's freedom of action do not, of course, stem exclusively from franchise statutes. One source of such limitations, for example (see 'Good Faith and International Franchising'), will depend on how a country has chosen to apply – or not to apply – this important doctrine. A critical facet of the franchisor–franchisee relationship is the degree to which the franchisor may restrict the franchisee's freedom of conduct. How will applicable law treat a franchisor's efforts to restrain the franchisee from carrying on any other business, especially one that may be



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deemed a competitor business? And, then, the franchisee's conduct after the sale of its business to a third party, or after the termination or the expiration of the franchise agreement? Much of the case law deals with the length of time during which, and the geographic area within which, a restriction may be imposed. 'Covenants Against Competition' addresses these issues in the context of a particular country but with broader ramifications.

Along with selecting the countries you wish to target, the decision of how best to go about the business of expansion is certainly at the threshold of your business and legal initiative. An understanding of these critical first issues will surely consume a sizeable share of the time on your flight, so you need to get a sense of how franchisors go about selecting the form of expansion that best suits the company's business model, culture and management practices ('Selecting the Appropriate Vehicle for International Expansion'). In addition, because you will want to be aware of other relevant possibilities, you will also want to examine 'Alternatives to Franchising'.

It is important to keep in mind that franchising is constantly evolving to take advantage of new techniques and approaches, prominent among which are e-commerce and social media (see 'Electronic Commerce, Social Media and Franchising'). As you will see, problems that arise are frequently attributable to a failure to address e-commerce adequately in the original franchise agreement and relationship.

Some components of the franchisor-franchisee relationship are so central that the legal doctrines relevant to them cut across almost every aspect of that relationship. Real estate is one such ubiquitous and critically important component. Consider, among numerous other examples of the pervasiveness of real estate, a situation where a franchisor and a franchisee are simultaneously a landlord and a tenant; or where it must be determined how much territory will be accorded to a master franchisee, area developer or development agent and, beyond that threshold issue, how rapidly must that territory be developed? And what happens after that goal is reached? These and many other issues are examined in 'Real Estate Development in the Cross-Border Franchise Context'.

You will surely want to turn to the heart of the franchise relationship and examine how the franchisor and the franchisee choose to express the bargain



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they have reached. Much of this process lies in understanding how elements of that bargain can best be articulated to leave as little as possible open to differing interpretations. However, the parties are not free to do entirely as they wish, nor is one party free to demand that its wishes be adopted in all respects, because franchise laws and other bodies of law impose limits and restrictions on both parties. Some of the key provisions of the franchise agreement are discussed in this volume.

Finally, consider widening your lens beyond the evaluation of a single country. That is particularly sensible in light of the strategy being adopted increasingly commonly by many franchisors – assessing an entire region in the interests of economy and efficacy. This volume addresses that approach in several chapters: ‘Franchise Regulatory Regime in Indonesia’ provides insight into the development of franchising in Southeast Asia, while ‘EU Competition Law’ surveys the application of a related body of law in a large and important market; and ‘Franchise Disclosure Documents Under Statutes in South America’ examines how the countries in a region have chosen to regulate the information that a franchisor must provide to a prospective franchisee.

*Ladies and gentlemen, we are now beginning our descent.*

You have not, of course, been exposed to every nook and cranny of franchise law. That would require, at a minimum, several trips around the world.

However, you can disembark now – you are off to a very good start.



**Philip F Zeidman**  
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Philip Zeidman devotes his practice to domestic and international distribution, licensing and franchising law. He served as general counsel to the International Franchise Association throughout his career, is counsel to a number of US and foreign companies and trade associations and has also served as special counsel to the Japan Franchise Association. He has engaged in an international transactional practice, testified on franchising before government



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bodies and appeared before business and professional groups in numerous countries. He was the first chair of the American Bar Association Antitrust Law Section's Distribution and Franchising Committee, was the chair of the International Franchising Committee of the International Bar Association and is the editor of *Legal Aspects of Selling and Buying* (Thomson/Reuters).

Who's Who Legal named him Global Franchise Lawyer of the Year for nine consecutive years, every year the award had been given, and in 2017 presented him with its Lifetime Achievement Award. Quoting from those interviewed, the publication referred to him as 'without doubt, the number one franchise practitioner in the world'. He has repeatedly been recognised by both *Chambers Global* and *Chambers USA*, which concluded: 'You'd have to be blind, deaf and dumb to not know Philip Zeidman'; and, in the 2020 editions, 'He is really the number one.'

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## Alternatives to Franchising

**Lee Plave and Abbey Taylor<sup>1</sup>**

### Introduction

Traditional franchising can be a successful expansion model for many businesses, even internationally, yet it is not always the correct choice. Franchisors, with the aid of legal practitioners and business consultants, must conduct an individualised analysis for every potential new market to choose the optimal expansion methodology to maximise benefits, take advantage of efficiencies and minimise drawbacks. Several common structures are used in international systems, namely company-owned operations, direct unit franchising (including direct single unit and multi-unit or area development agreements), master franchise agreements, joint ventures and, in the United States, exemption-based franchising. Each has advantages and disadvantages in light of the characteristics of the target market. This chapter focuses on certain aspects of two specific alternatives to traditional franchise systems: joint ventures and exemption-based franchising.

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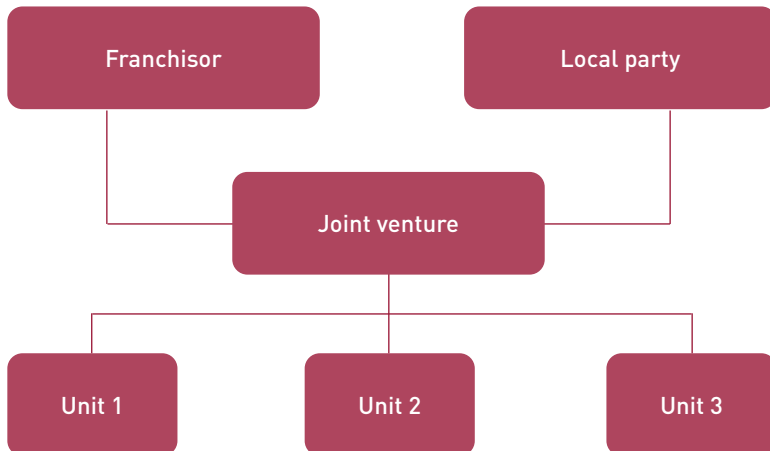


## Joint ventures

Establishing an international joint venture necessitates detailed planning and thought-out strategy but can culminate in success and creation of a lucrative enterprise. As the name implies, a joint venture requires a second party to join in your venture. Joint ventures can arise for a variety of reasons, including satisfying local ownership requirements in certain countries and leveraging the benefit of collaborating with a strong and experienced joint venturer. With the right business partner and the right market, a joint venture can be a successful, efficient and less costly alternative to franchising.

### Overview of joint ventures

There is no single definition of the term 'joint venture'. A joint venture can adopt many different forms, styles, understandings and arrangements. 'An international joint venture is often described as the joining together of two or more business partners from separate jurisdictions to exchange resources,



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share risks and divide rewards from a joint enterprise.<sup>2</sup> In a joint venture, the franchisor and a local entity in the target country jointly form a new entity for purposes of executing franchise development in the region.

In this model, each party holds an equity interest in the entity, the proportions of which will vary significantly depending on the parties' desired goals, their respective bargaining positions and the market's legal and economic practicalities. The franchisor typically grants a master franchise agreement<sup>3</sup> to the joint venture entity (in which it holds a proprietary stake), retaining a level of direct control proportionate to its interest. In this sense, the joint venture represents something of a compromise between the relinquished control of a master franchisee relationship<sup>4</sup> and the retained control of a subsidiary. (Of course, because the joint venture entity will itself become a franchisee or a master franchise, the joint venture approach does not eliminate the need to consider the impact of applicable franchise laws.)

The joint venturer's role will vary depending on the nature of the target market. If the purpose of the joint venture is merely to satisfy local ownership requirements, the local party may have a limited role in the running of the franchised business. Conversely, joint venture partners, like master franchisees, can often have an impactful role in adapting the franchise system to local commercial customs and market conditions, applying their resources, regional knowledge

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2 See Milton R. Stewart and Ryan D. Maughn, *International Joint Ventures, A Practical Approach*, Davis Wright Tremaine LLP (2011).

3 'The Master Franchise Agreement . . . is a type of franchise agreement that allows the Master Franchisee the right to own and operate more than one establishment (called unit), and the right to sub-franchise the right to open units to other independent businesses (called Franchisees), all during a specified time within a specific area.' Olegario Llamazares, *What is a Master Franchise Agreement?*, Global Negotiator (Oct. 16. 2014).

4 'Under a master franchise agreement, in addition to having the right and obligation to open and operate a number of locations in a defined area, the master franchisee also has the right and the obligation to offer and sell franchises to other people looking to become franchisees of the system. The master franchisee becomes the franchisor in their market area.' Michael Seid, *Franchise Relationship Structures*, MSA Worldwide.



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and influence.<sup>5</sup> Subject to individual bargaining and to ownership percentage requirements that may apply under law in the target country, franchisors may increase their ownership interest and control level proportionately with their experience in the foreign markets.<sup>6</sup>

### Potential advantages and drawbacks of joint ventures

A joint venture is not a guaranteed success. The decision to enter a joint venture, especially internationally, must be carefully considered. Increased control, reduced capital investment, reduced risk, local entity status and the potential for favourable tax treatment are some of the factors that make joint venture relationships attractive expansion structures. However, entity complexity and increased exposure to local antitrust and competition laws are factors that may detract from joint ventures' benefits.

#### *Potential advantages*

Joint ventures offer advantages relative to the structure of a subsidiary or branch office because they allow the franchisor to integrate its venture partners' local industry knowledge, methods and distribution networks, as well as quickly assimilate into the new market.<sup>7</sup>

In a traditional franchise system, the degree of control that a franchisor has over its franchisee is, in principle, limited by the contractual terms in the franchise agreement and the practical nature of the franchisor–franchisee

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- 5 Plave, *Deciding to Go International: Organizational and Business Considerations*, in *Fundamentals of International Franchising*, Ch., at 19 (Am. Bar Assoc., Woods, ed., 2d ed. 2012).
  - 6 Sixt Rent A Car Inc. increased its equity interest in its Singapore franchise development joint venture from 65 per cent at initial venture outset to 88 per cent as its region-specific knowledge increased over time. See Maria Jell-Ojobor & Josef Windsperger, *Determinants of the Governance Structure of the International Franchise Firm*, 34 *Int'l Mktg. Rev.* 814, 834 (2017).
  - 7 See Hufei Ge, Silu Chen & Yujie Chen, *International Alliance of Green Hotels to Reach Sustainable Competitive Advantages*, 10 *Sustainability*, No. 2, 2018, at 4.



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arm's-length relationship. Some franchise relationships face substantial challenges because of control issues – the franchisor may prefer a higher level of control than that desired by the franchisee. Franchisors can seek to establish brand control through their franchise agreements, establishing precise brand standards and retaining extensive rights to inspect, control and supervise franchisees, yet franchisees may balk at controls they perceive as excessive. Although franchisees do generally stand to benefit from the opportunity to capitalise on and leverage the franchise intellectual property, branding, business system, marketing strategies, etc, they also invest heavily, especially during the initial stage of setting up the business, and often consider their franchises to be their own businesses.

In a joint venture, the franchisor can retain a measure of joint control over its international enterprise through the contractual relationship with its local joint venturers and, at the corporate level, through the shareholders' agreement. Depending on the franchisor's equity interest and voting rights, a joint venture franchisor may have a board seat and other levers that allow the franchisor to assert a greater degree of control. Members of a joint venture typically have statutory and contractual rights – and obligations – proportionate to their shareholding in deliberations over business growth, strategy, etc. The franchisor is still obliged to transfer certain of its know-how pursuant to the franchise agreement, but the joint venture structure usually places the franchisor in a position to monitor more closely and easily how that know-how is used in practice. High levels of franchisor control can be particularly advisable where there are high levels of institutional uncertainty and limited formal protections for businesses, to mitigate the increased risk of 'brand hijacking' and other harmful practices.<sup>8</sup> The magnitude of this risk can dictate the franchisor's bargained-for ownership interest in the joint venture.<sup>9</sup>

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<sup>8</sup> See Hufei Ge, Silu Chen & Yujie Chen, *International Alliance of Green Hotels to Reach Sustainable Competitive Advantages*, 10 *Sustainability*, No. 2, 2018, at 853.

<sup>9</sup> Europcar's franchise development scheme in Asia adopted different control proportions in Singapore and in China because of differences in institutional uncertainty. See Jell-Ojobor & Windsperger, *supra* note 6, at 819.



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The basis of a joint venture stems from the sharing and pooling of resources and competence for a specific business purpose. Parties come together synergistically, leveraging their respective areas of competence, knowledge and resources to achieve their mutual business objectives, and the business purpose is often much wider in scope than a conventional grant of rights to use the intellectual property of the franchisor and sell products. The availability of the local partner's business infrastructure, knowledge and supply and distribution networks can drastically reduce the drain on franchisor resources that generally accompanies a solo foray into a new market, and the local partner's capital contributions obviously constitute proportional relief for the franchisor. A joint venture partner shares responsibility for profits and losses according to the predetermined ratio and may participate in the day-to-day operation of the franchise system. By sharing the equity ownership or financial commitment in the form of loans or convertible bonds, and by pooling resources for operating the joint venture entity, the franchisor and local partner both contribute significantly to successfully launch and sustain the business, and both may benefit significantly thereby. For the purpose of obtaining visas and work permits, the local entity may also act as a host to the personnel of the foreign franchisor being dispatched to the area for management or training.

### *Potential disadvantages*

One drawback of the joint venture route may be the burdensome procedure and administrative expenses of setting up a new entity. The necessity of statutory licence registration and compliance with regional laws and regulations for corporate formation can increase the risks and costs of doing business in a new jurisdiction. The formation and execution of a watertight joint venture shareholders' agreement can also be an onerous task, but its importance cannot be overstated. Exit options (such as strategic third-party sale, merger and acquisition, buyback, drag-along or tag-along rights, and call or put options if a deadlock occurs) must be well thought out and drafted, and there must be a detailed valuation methodology for exiting shareholders.



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In the event of a deadlock between joint venturers, there are practical challenges in exiting the venture and winding up the entity<sup>10</sup> – in part because the relationship is bound by at least two principal agreements: (1) the (master) franchise agreement between the franchisor and the joint venture entity; and (2) the joint venture agreement (eg, the shareholders' agreement) between the joint venturers. Here, the contractual relationship between the joint venture partners cannot be terminated simply by terminating the (master) franchise agreement, which would be the case in a traditional franchise arrangement; rather, there is the added layer involving the joint venture agreement. Thus, even in the case of a dispute between the franchisor and the franchisee, the joint venture relationship between the joint venture parties would continue – and, consequently, so too would the franchise business – while the dispute is being resolved. In other words, if the joint venture partners seek to terminate the franchise relationship, the joint venture partner must consider that its other partners must also carry out the winding-up of the joint venture entity – that is, the joint venture partners would need to terminate the joint venture agreement. This significant legal (and regulatory) step would weigh against terminating the franchise relationship that is being governed under the (master) franchise agreement and the joint venture agreement. As such, there are practical challenges in exiting the joint venture and winding up the joint venture entity in the event of a falling-out of the joint venture partners.

Additionally, among the many other factors to consider are potential drawbacks. For example, the joint venture entity as noted above is likely to be deemed a 'franchisee'. While that may be a technical interpretation of the parties' relationship, it is a technical reality as well. Although in the United States, under the Federal Trade Commission (FTC) Franchise Rule, the sale of an interest in a franchisee is not considered to be the sale of a franchise, that is not the case

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**10** In addition, although forming a separate joint venture entity may result in favourable tax treatment for franchisors, the resulting corporate complexity can make the tax filing process more burdensome. Under some jurisdictions' tax or corporate laws (as well as national generally accepted accounting principles), the joint venture's financials may have to be consolidated into the franchisor's financial statements where the franchisor exercises substantial and de facto control over the joint venture entity.



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under every state franchise law.<sup>11</sup> A significant consideration in this regard is which party holds the majority or controlling interest in the joint venture. If the joint venturer is the controlling party, it can and might assert a claim that the grant of the (master) franchise to the joint venture was subject to (and possibly in violation of) applicable franchise laws. On the other hand, if the franchisor is the controlling party, the joint venturer is likely to be unable to assert a claim with respect to the 'sale' of the franchise, but there may be other considerations that need to be taken into account (eg, under securities law relating to the shareholding in the joint venture entity).

The relative shareholding of the franchisor and the joint venturer is a significant consideration in evaluating whether to enter a joint venture with the other party. Some franchisors would rather not be a non-controlling party in the joint venture, having to undertake the obligations and suffer the corporate indignities of being the junior partner. A famous quote on this point is illuminating: '[t]here is nothing in life quite so limited as being a limited partner of George Steinbrenner.'<sup>12</sup> A franchisor may find that being the junior partner in a joint venture is less desirable once the relationship is under way.

Additionally, in a joint venture, the partners are likely to owe a fiduciary duty to the combined entity and perhaps to their co-venturers as well.<sup>13</sup> That enhanced fiduciary duty may complicate an otherwise arm's-length relationship between a franchisor and its franchisee.

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**11** 16 C.F.R. § 436.1(i); see also 72 Fed. Reg. 15444, 15460 [2007] [2007 SBP]. Some states' laws are silent on this point and it is reasonable to infer that although those laws apply to the sale of a franchise to a franchisee, they do not apply to the sale of an interest in a franchise. See, eg, Md. Bus. Reg. Code § 14-201(e) [definition of franchisee is 'a person to whom a franchise is granted']. In contrast, some state laws specifically indicate that the sale of an interest in a franchise falls under the state law. See N.Y. Gen. Bus. L. § 681(11), (13), and (15); and Va. Code § 13.1-559(A).

**12** Wallace Matthews, *Could Yanks say YES to takeover?*, ESPN (Nov. 19, 2012).

**13** See, eg, *Phillips v Reed Grp., Ltd.*, 955 F. Supp. 2d 201, 245 [S.D.N.Y. 2013] [joint venture partners owe one another fiduciary duties]; *In re Cavalry Constr.*, 428 B. R. 25, 35 [S.D.N.Y. 2010], *aff'd*, 425 F. App'x 70 [2d Cir. 2011]; *Silverstein v Last*, 383 A.2d 718, 721 [N.J. Super. Ct. App. Div. 1978].



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Finally, there may be formalities that need to be taken into consideration, including antitrust and competition law filings and compliance requirements.

## Exemption-based franchising

In the United States, there are several types of franchises that American legislators have determined do not merit the stringent oversight that other franchises require. These types of franchises have been granted 'exemptions' from federal and state franchise law.

### Overview of exemption-based franchising

#### *Disclosure in general*

The United States has laws that regulate the offer and sale of franchises at both national and state levels. Unfortunately, and much to the consternation of some in the field, the federal and state rules are not always aligned. The federal Franchise Rule, promulgated by the FTC, is relatively simple and simply requires franchisors to disclose certain information to prospective franchisees. This is done in the form of a franchise disclosure document (FDD).<sup>14</sup> Franchisors are not required to file their FDD with the FTC. The FTC simply sets a disclosure standard and, where needed, enforces that requirement.

#### *Registration requirements*

Fourteen states have added additional franchise registration or disclosure laws on top of the FTC Franchise Rule. These states (the Registration States) require a franchisor to go a step further than just preparing an FDD. The requirements vary and generally require a franchisor to make a filing and seek

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<sup>14</sup> The FTC Franchise Rule, 16 C.F.R. Part 436, originally took effect on October 21, 1979 (the Original Rule) and was substantially amended with effect from July 1, 2007 (the Amended Rule). The FTC published a Statement of Basis and Purpose when it adopted the Original Rule, 43 Fed. Reg. 59621 (1978), and similarly published a Statement of Basis and Purpose when it adopted the Amended Rule – the culmination of a 12-year rule-making process. See 2007 SBP, *supra* note 11.



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either registration or some form of exemption from the registration requirements in each of those 14 Registration States. These states require both registration and disclosure using the FDD, in the absence of an exemption.

### *Exemption-based franchising*

The phrase 'exemption-based franchising' is at once accurate and a misnomer. There are many companies that have chosen this path to expansion, under which the franchisor awards contracts (actually, franchise agreements) but only in transactions where there is an applicable exemption whereby the franchisor is not required to comply with the FTC Franchise Rule or state franchise laws.<sup>15</sup>

The FTC and many of the Registration States provide limited exemptions on a transaction-by-transaction basis from the requirement to provide disclosure (at both levels) and the requirement to register the FDD (at the state level). And when there are federal and state exemptions, the transaction may be conducted using exemption-based franchising. Federal and state exemption requirements vary significantly, and requirements also vary from state to state.

### Federal exemptions

When the FTC promulgated the Amended Rule in 2007,<sup>16</sup> the federal exemption list grew to include eight exemptions. Of these, for cross-border transactions,

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**15** Although some may refer to an exemption-based franchise as a 'licence', if all three of the elements needed to establish that the business relationship is a franchise (as noted below), the name that the parties choose to describe their relationship is of no consequence.

Those three elements are: (1) the grant of the right to use the franchisor's mark; (2) substantial assistance provided to or control of the franchisee; and (3) the payment of a required fee. 16 C.F.R. § 436.1(h). The definition is consistent under the FTC Franchise Rule and all the states with franchise laws, except for New York – under the New York Franchise Law, any combination of elements 1 and 3 above, or 2 and 3 above, will be deemed a franchise. N.Y. Gen. Bus. L. § 681.3.

**16** See the Amended Rule, *supra* note 14.



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the large franchisee exemption and large investment exemption are often the most likely to apply and serve a useful purpose in appropriate transactions.

The FTC Franchise Rule exemptions, in general terms, are the following.

- Large franchisee exemption – transactions in which the franchisee (including its affiliates) has (1) been in any business for at least five years; and (2) has a net worth of at least US\$6,165,500.<sup>17</sup>
- Large investment exemption – transactions in which there is a large investment (meaning that the franchisee, and, in particular, one of its principals, will need to invest at least US\$1,233,000 in the business opportunity (not counting the cost of buying unimproved land and also excluding financing provided by the franchisor).<sup>18</sup>
- Fractional franchise exemption – transactions in which the franchisee has two or more years of experience in the same type of business as the franchise being offered by the franchisor, and the franchisee and franchisor reasonably believe that, in its first year of operation, the new franchised business will not account for more than 20 per cent of the franchisee’s total sales.<sup>19</sup>
- Minimum payment exemption – a franchisee may not make required payments, or commitments to make required payments, over US\$615 to the franchisor or an affiliate of the franchisor during the first six months of operations.<sup>20</sup>
- Insiders exemption – franchise sales to two categories of insiders are exempt: either (1) to officers, directors, general partners or managers of a franchisor, or (2) to owners of a franchisor.<sup>21</sup>
- Leased departments exemption – applies when ‘the only payment by the independent retailer-tenant that occupies space within a larger retailer-landlord’s premises is rent. The exemption does not apply if the

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**17** 16 C.F.R. § 436.8(a)(5)(ii). The FTC periodically adjusts for inflation the threshold levels for all these exemptions, mostly recently in 2016. 81 Fed. Reg. 31500-01 (2016). Additional adjustments are likely.

**18** 16 C.F.R. § 436.8(a)(5)(i).

**19** 16 C.F.R. § 436.8(a)(2).

**20** 16 C.F.R. § 436.8(a)(1).

**21** 16 C.F.R. § 436.8(a)(6).



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retailer-tenant must directly or indirectly purchase goods or services from the retailer-landlord or from suppliers required or approved by the retailer-landlord.<sup>22</sup>

- Petroleum marketers and resellers exemption – exempts petroleum marketers and resellers protected by the Petroleum Marketing Practices Act.<sup>23</sup>
- Oral contracts exemption – purely oral or verbal relationships with no written evidence describing material terms or any aspect of the relationship or arrangement.<sup>24</sup>

### State-specific exemptions<sup>25</sup>

There are 14 Registration States, all requiring some form of state registration: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. State franchise laws (all of which were adopted before the FTC issued the Franchise Rule in 1978) were intended to ensure that franchisors provide disclosure to prospective franchisees. To accomplish that, the Registration States' franchise laws generally require the FDD to be submitted to the state authorities for review and approval.

Even so, most of the Registration States afford some transaction-level exemptions that can eliminate the requirement to comply with the registration requirements and, usually (but not always), the state-level disclosure requirements (which typically duplicate the FTC Franchise Rule requirements). The criteria for qualifying for an exemption vary by state but typically are somewhat similar to the federal exemptions, with different standards in some cases. For example, nine of the registration states have some form of the large franchisee

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**22** See 16 C.F.R. § 436.8(a)[3]. See generally ABA Exemption Deskbook, *infra* note 25.

**23** 16 C.F.R. § 436.8(a)[4].

**24** 16 C.F.R. § 436.8(a)[7].

**25** The ABA Forum on Franchising published a thorough guide covering state-specific exemptions. See Leslie D. Curran and Beata Krakus, *Exemptions and Exclusions Under Federal and State Franchise Registration and Disclosure Laws*, Am. Bar. Assoc. (2017) (the ABA Exemption Deskbook).



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exemption and 11 of the registration states have adopted some version of the fractional franchise exemption.<sup>26</sup> Some exemptions that appear in the registration states are unique, such as an exemption in some states for out-of-state franchise transactions, and another exemption, available in some states, for the sale of an additional franchise to an existing franchisee. It is absolutely necessary to review each state law that applies to determine whether to consider the exemption-based model.<sup>27</sup>

Some Registration States make available an exemption for 'isolated sales' (eg, where the franchisor makes a limited number of franchise offers). For example, the New York isolated sales exemption is available where the franchisor makes an offer to two or fewer parties, does not grant subfranchising rights nor pays a brokers' commission, and where the franchisor makes a filing with the state (if it is not a New York domiciliary).<sup>28</sup> Similar exemptions are also available, applying different state-specific criteria, in Indiana,<sup>29</sup> Minnesota<sup>30</sup> and Washington.<sup>31</sup>

Another potentially useful state-level exemption is for transactions with franchisees that already operate 'substantially similar' businesses. These

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**26** See David B. Ramsey et al, *Exemption-Based Franchising for Established and Start-Up Franchisors*, International Franchise Association 50th Annual Legal Symposium (2017), at 23, 26-27.

**27** See Leslie D. Curran and Karen B. Satterlee, *Exemption-Based Franchising: Are You Playing in a Minefield*, 28 Franchise L. J. 191 (2009). See also ABA Exemption Deskbook, *supra* note 25.

**28** N.Y. Gen. Bus. Law § 684(3)(c).

**29** Ind. Code § 23-2-2.5-3 (the statute does not apply 'to the offer or sale of a franchise if the franchisor . . . sells no more than one {1} franchise in Indiana in any twenty-four {24} month period. . .').

**30** Minn. Stat. Ann. § 80C.03(a).

**31** Wash. Rev. Code § 19.100.030(4)(b)(ii).



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are available in many but not all the Registration States (eg, California<sup>32</sup> and Maryland<sup>33</sup>) and may apply when a franchisor offers a franchise that is substantially similar to an existing franchise's business.

It is critically important to review each state whose law might apply to determine whether to carry out expansion through the exemption-based model.

If a transaction might fall within the coverage of the law that applies in a Registration State, three analyses should be conducted.

First, a careful examination of the scope of the Registration State law should be undertaken. Not all the Registration State's laws apply to every transaction, even when there is a franchisee domiciled in that state or even a business to be operated in that state. A proper review will reveal whether the state law applies at all.

Second, some state franchise laws have a franchisor-level exemption that might apply to the franchisor. For example, in New York, a franchisor with an audited net worth of at least US\$15 million is automatically exempt from

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**32** Cal. Corp. Code § 31018. The California regulator issued a statement in 1997 to provide details on when the exemption would be available, noting that '[t]he owner or owners have had, within the seven years before the date of the sale or other transaction, at least 24 months experience being responsible for the financial and operational aspects of a business offering products or services substantially similar to those offered by the franchised business.' Cal. Dep't Corps., Release No. 13-F: Notice of Exemption For Use With 'Experienced Franchise Purchaser' Exemption Under Corporations Code Section 31106 (Feb. 10, 1997), *reprinted in* Bus. Franchise Guide (CCH) ¶ 5050.47. Franchisors must also satisfy a filing requirement to claim this exemption. Cal. Code Regs. tit. 10, § 310.101.

**33** Md. Code Ann., Bus. Reg. § 14-214(b)(2). The Maryland statute does not specify whether the existing business has to be the same as that of the new business (eg, an additional franchise for the same brand). The Maryland Attorney General's office issued an advisory opinion in 1998 addressing this exemption but merely noted that the sale of an additional business to an entity comprising the same ownership group as that of another franchisee would fall within the exemption; the opinion did not address the possibility of the prospective franchisee having experience with a similar but different franchised business). Md. Off. Att'y Gen. Sec. Div., Advisory Op. 98-1 (Apr. 14, 1998), *reprinted in* Bus. Franchise Guide (CCH) ¶ 5200.21.



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the state registration and disclosure requirements (so long as the franchisor provides the name of its agent for service of process in New York).<sup>34</sup> Other states also have a 'large franchisor' exemption and require a threshold level of net worth (ranging between US\$5 million and US\$15 million) and some element of 'experience', which is typically measured in the number of franchised or company-owned units that have been operating over the previous five-year period.<sup>35</sup> None of these laws specify that the audited financial statements must be expressed in US dollars or that the units must be operated within the same state or in the United States. Other than in New York, these other states' large franchisor exemptions may relieve a franchisor from the obligation to register, but they will not eliminate the need to provide disclosure (eg, an FDD) to prospective franchisees and, consequently, the large franchisor exemptions outside New York may not be of substantial utility without a transaction-level exemption, as discussed below.

Third, if a Registration States law applies, there should be a careful examination of whether a state-level exemption might apply and, if so, whether it makes legal and commercial sense to rely on that exemption, as discussed above in this subsection.

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**34** N.Y. Gen. Bus. Law § 684(3)(a). A second exemption from the registration requirements is also available for a franchisor with an audited net worth of US\$5 million that requires limited disclosure of some details regarding the franchisor. *id.* § 684(2)(a).

**35** See, eg, the California Franchise Investment Law, Cal. Corp. Code § 31101 (under the California Franchise Investment Law, a franchisor can claim an exemption from the registration – but not disclosure – requirements if it has a net worth of US\$5 million or more and either has operated 25 units or has had 25 franchised units of the same type as that being offered by the franchisor over the previous five years); the Illinois Franchise Disclosure Act, 815 Ill. Comp. Stat. 705/8(a)(1) (which provides a self-executing exemption from the registration requirements of the state law for a franchisor with an audited net worth of at least US\$15 million); and the Maryland Franchise Law, Md. Code Regs. 02.02.08.10(D) (which requires a US\$10 million audited net worth and at least 25 franchisees operating the franchised business for the trailing five-year period, as well as an application filed with the state examiner for this registration exemption).



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## Advantages and disadvantages of exemption-based franchising

While there are strategic considerations to exemption-based franchising, the most important consideration is, of course, whether an exemption applies at all. Only after ensuring that a federal or state exemption applies can the following strategic considerations be discussed. Some in the field advocate for a four-step inquiry into deciding whether to utilise exemption-based franchising, 'To do an analysis of exemptions available to a franchisor, the franchisor must ask four key questions: (1) do any federal exemptions apply? (2) do any state exemptions apply? (3) do the applicable exemptions relieve only registration obligations or also relieve disclosure obligations? and (4) even if exemptions are available, does the franchisor prefer to register and disclose anyway?'<sup>36</sup> Below are considerations to take into account when making the decision to take advantage of a federal or state exemption.

### *Advantages of exemption-based franchising*

One major incentive for franchisors to consider turning to an exemption is to cut regulatory compliance costs and processes. An exemption may obviate the need to undertake the legal expenses involved with creating, maintaining, drafting and registering an FDD.

Utilising exemption-based franchising can also allow a franchisor to avoid certain practical inconveniences. Under the FTC Franchise Rule, the FDD must be renewed yearly, within 120 days of the franchisor's fiscal year end<sup>37</sup> (more frequently if there are mid-year material changes).<sup>38</sup> At the state level, FDD expiration and renewal dates vary depending on prior year registration and state-specific requirements. If the renewal deadline is missed, a franchisor must 'go dark' – meaning the franchisor cannot offer to sell franchises until the FDD is completed. This process will require planning and coordination, especially for the Registration States, as some states require a renewal application and approval of the FDD by the deadline. If the prior registration has

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**36** ABA Exemption Deskbook, *supra* note 25, at 8.

**37** 16 C.F.R. § 436.7(a).

**38** 16 C.F.R. § 436.7(b).



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expired, the franchisor may be required to file an initial application or a re-statement application. With exemption-based franchising, there is no risk of missing renewal deadlines and, thus, no risk of going dark.

If a franchisor is not exempt, the franchisor must prepare an FDD. The FDD must contain specific information regarding 23 items:<sup>39</sup>

- background information on the franchisor, its parents, predecessors and affiliates;
- five-year biographical information for the franchisor’s directors, trustees, general partners, principal officers and any other individual having management responsibility relating to the sale or operation of franchises;
- disclosure of certain litigation and arbitration proceedings relating to the franchisor, its predecessors and affiliates;
- bankruptcy filings by the franchisor, any parent, predecessor, affiliate, officer, general partner or any other individual who will have management responsibility relating to the franchise;
- all fees and payments, or commitments to pay, made by the franchisee before opening the franchise;
- all fees paid to the franchisor or its affiliates after opening the franchise;
- the estimated initial costs that a franchisee will incur to open a franchise;
- disclosure of restrictions on sources of products to be used at a franchise location;
- information relating to other franchisee obligations in respect of the franchisor;
- disclosure of any financing (including leases and instalment contracts) offered directly or indirectly by the franchisor, its agent or affiliates;
- information relating to any assistance offered by the franchisor, including training programmes, computer systems and marketing;
- a description of the territory granted to the franchisee and any limitations;
- information concerning trademarks;
- information concerning patents, copyrights and proprietary information;

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**39** The franchisor bears the burden of proof that it properly relied on an exemption. See *Dollar Systems, Inc. v Avcar Leasing Systems, Inc.*, 890 F.2d 165 (9th Cir. 1989).



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- disclosure of any obligation for the franchisee to participate personally in the direct operation of the business;
- disclosure of any franchisor-imposed restrictions or conditions on goods or services;
- disclosure of certain agreement provisions relating to renewal, termination, transfer and dispute resolution;
- disclosure of whether a public figure is paid by the franchisor for use of their name or assistance in selling franchises;
- disclosure of whether the franchisor is making any financial performance representations and details about those representations;
- a summary of franchised and corporate outlets;
- the franchisor's financial statements;
- a copy of all contracts a franchisee must sign at the outset of the parties' relationship; and
- a receipt page for the FDD.<sup>40</sup>

The FDD requires disclosure of specific details about not only the franchisor entity but also its parent companies and predecessors, and even information about the individuals with management responsibility within the franchisor entity. As noted above, the FDD requires disclosure of considerable detail. Exemption-based franchising does not require preparation of an FDD, which can provide an efficient and cost-effective alternative to traditional franchising.

### *Disadvantages of exemption-based franchising*

The advantages of exemption-based franchising are compelling, but the decision to follow that path requires careful consideration in view of its limitations.

The most significant limitation, in practical terms, is that a franchisor relying upon exemption-based franchising may have to forego transactions for which an exception is not available. That requires commercial discipline and inevitably requires making some difficult business judgements when it is not feasible

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<sup>40</sup> See 16 C.F.R. § 436.5.



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to conduct desirable transactions under an exemption and, therefore, these transactions cannot be undertaken without providing the disclosure needed to meet state or federal requirements.

Another consideration is that with state and federal regulatory schemes operating together, some transactions may be exempt at the federal level but not at the state level, or vice versa. Again, this dynamic will require that the franchisor and its team exercise considerable discipline.

Additionally, in an exempt transaction, the franchisee will not have the FDD, which, when given, can help educate the franchisee and help defend a claim that the franchisee was unaware of certain details (obligations, costs, restrictions, responsibilities or duties) involved in operating a franchise.<sup>41</sup> Although claims of this nature are not likely to be raised by larger entities or institutional franchisees, a smaller franchisee that, nonetheless, qualifies for an exemption might assert such a claim in a dispute. In that situation, a franchisor that provided its FDD would be in a position to rebut those claims (no matter what merit those claims may have or lack).

## Conclusion

There are many options for entering a market, including the traditional franchise model, but it is important to know and to assess alternatives to that approach. Depending on the target market, the franchisor's business plans and its approach to administering transactions, an alternative may be a sensible consideration if not a preferable path. Joint ventures and exemption-based franchising are commonly used vehicles that can provide excellent opportunities to pursue growth and success in a business outside conventional unit-by-unit, multi-unit development or master franchising.

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<sup>41</sup> See ABA Exemption Deskbook, *supra* note 25.



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