Dependence and Reliance:

Keys to Unshackling Co-Branding Alliances From Federal Franchise Rule Compliance

By Charles B. Cannon

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As franchising approaches the twenty-first century, co-branding alliances hold continuing appeal for companies seeking to expand in non-traditional ways. The variety of forms co-branding alliances can take is limited only by the imaginations of creative business people and their lawyers. The forms range from elaborate subfranchising arrangements between established franchise companies to experiments between a one-store merchant and a product distributor, and all points in between.

Several commentators have examined the structures in which co-branding alliances are commonly cast and have discussed the practical challenges an alliance entails for both partners.[1] Most of these commentators acknowledge the desirability of avoiding franchise regulation in forming an alliance yet none has given detailed attention to the circumstances under which alliance partners may escape compliance with pre-sale registration and disclosure laws.

The avoidance of pre-sale regulation holds attraction for most would-be alliance partners. The effort to identify and perfect an exemption can prove especially rewarding to those who want to reduce their transaction costs, increase flexibility in negotiating and structuring an alliance, or defuse hostility from hosts who lack familiarity and sympathy with the legal constraints that apply to franchising. [Generally, "hosts" are alliance partners who operate or control locations into which the branded products or services of the other alliance partner (the "guest") are introduced or who own a business concept to which a guest's branded products or services are annexed. The guest's branded products or services complement or supplement the host's core business.]

Younger, less affluent guests find that pre-sale registration and disclosure requirements can pose a significant barrier to entry into co-branding. The barrier may not arise if a proposed alliance simply involves variations on themes the guest has developed in its basic franchise documents. In that case, the guest may reasonably characterize the alliance agreement as a negotiated change of its basic franchise contract and rely on that characterization to avoid the delay and expense an amendment—much less a separate registration—entails.

Mr. Cannon is with the firm of Locke, Purnell, Rain & Harrell in Dallas, Texas.

More likely, an alliance will involve a radical departure from the guest's traditional franchise program. From the outset, the parties may contemplate a subfranchising arrangement foreign to the guest's traditional pattern of single-unit franchising. Or the guest may approach the host with a proposal to install non-standard variations of the guest's traditional franchised outlets (such as express units, kiosks, or carts). It may also offer the host a uniquely favorable fee arrangement or other concessions it would never make available under its standard franchise offering. In these and myriad other circumstances, the guest's proposal might differ so significantly from the terms of its basic franchise program that reliance on a negotiated change characterization seems tenuous, if not foolhardy.

In these cases, younger, less affluent franchisors face difficult choices. Unless they can find a way to avoid pre-sale registration and disclosure, they must either stretch their resources beyond tolerable limits to register, amend a franchise offering for an alliance that may never come to fruition, shy away from attractive alliance opportunities, or assume the risk of ignoring the law.

Even wealthy, seasoned companies can benefit from avoiding the rigors of pre-sale compliance. Co-branding alliances frequently begin with a test phase that allows the partners to verify their concepts' operational compatibility and to add definition to their original working proposal. A test may produce relatively modest changes in the ongoing relationship, affecting such secondary issues as development schedules, training requirements, or supply arrangements. On the other hand, a test may lead the parties to recast the basic structure of their relationship. For example, test results may persuade the host to take a more passive role than the parties originally envisioned, causing them to abandon a subfranchising arrangement in favor of direct franchising between the guest and the host's franchisees.

If a test is to produce the optimum results with minimal administrative effort and expense, the partners must retain flexibility to adjust their relationship on the fly. They need room to tinker with the alliance's operational and contractual structure without artificial delays or expenses. They also need to share cost information, financial projections, and other financial data without running afoul of the restrictions on earning's claims. Without the benefit of an exemption from franchise regulation, guest franchisors cannot easily navigate through a test without experiencing annoying delays and expense—or ignoring the law.

Many co-branding alliances involve hosts who lack familiarity with franchising and often demonstrate a skeptical, even hostile attitude toward franchising's business and legal constraints. Managers of sports arenas, convention centers, airport terminals, and similar venues often balk at accepting the subservient role of franchisee. They also scoff at suggestions there should be limits on free-wheeling contract negotiations or exchanges of financial information. When confronted with these attitudes, owners of less powerful brands may lean toward ignoring the law rather than scuttling a lucrative alliance.

When cost or expedience pressures a guest to disregard the law, counsel can sometimes forestall ill-advised action by suggesting ways an alliance can be structured to avoid presale regulation. An escape from regulation will not always prove possible—or even desirable. Some alliances must include all the elements of a common franchise to maintain operational integrity and financial stability. In most cases, however, the rewards of locating an escape route justify the effort to find one.

Several paths lead to the goal of unregulated alliances. Some paths emerge from the definitions of franchise, others from exemptions or exclusions provided by statute or regulation. These paths diverge somewhat at the federal and state levels because of differences in statutory schemes and regulatory philosophies. No state uses the federal definition of franchise. There is no consistent pattern of exemptions in the federal and state approaches to franchise regulation, or even among the states.

Although no analysis of a co-branding alliance is complete until counsel examines both federal and state law, this article limits its attention to federal issues. It focuses on two avenues alliance partners can follow to avoid compliance with the Federal Trade Commission's Franchise Rule.[2] One avenue emanates from the second element of the FTC's definition of franchise—the so-called "significant control or assistance" element. The other avenue involves the Franchise Rule's fractional franchise exemption.

Two concepts underlie the second element of the Franchise Rule's definition of franchise and its fractional franchise exemption—the concepts of franchisee dependence and franchisee reliance. This article examines these fundamental concepts with the objective of providing franchise counsel analytical tools they can use to construct co-branding alliances that are not subject to federal regulation.[3]

The Roles of Dependence and Reliance in the FTC's Definition of Franchise

The Franchise Rule contains a three-pronged definition of "franchise." Generally, a franchise involves an ongoing commercial relationship in which: (1) the franchisee obtains the right to sell the franchisor's branded products or to operate under the franchisor's trade name; (2) the franchisor exercises significant control over the franchisee's operations or provides significant assistance to the franchisee; and (3) the franchisee pays a fee.[4] The definition is phrased inclusively; a relationship must satisfy all three elements before a franchise materializes. Thus, if alliance partners design a relationship that avoids any of the three elements, the relationship will not be subject to regulation as a franchise under the Franchise Rule.

Guests have no incentive to avoid the trademark element of the Franchise Rule's definition. Their motivation is to broaden their brand name or service mark's exposure and to increase its recognition among the host's customers. Withholding authority for the host to display the guest's trademark or service mark would run counter to the guest's objectives.

Guests occasionally structure their programs with a view toward avoiding the fee element. However, a guest runs the risk of artificially skewing an alliance's economic foundation by eliminating financial benefits it would demand from traditional franchisees. An attempt to evade the fee element makes sense only when an alliance offers a guest long range economic benefits that counterbalance the surrender of an immediate fee.

The most fertile source of definitional relief lies in the control or assistance element. Under the Franchise Rule's definition, a franchise will not emerge unless "the franchisor exerts or has authority to exert a significant degree of control over the franchisee's method of operation . . . or . . . gives significant assistance to the franchisee in the latter's method of operation. . . ."[5]

The Interpretive Guides to the Franchise Rule[6] indicate that a determination of significant control or assistance involves an inquiry into two dimensions of a commercial relationship: first, the degree to which the franchisee depends on the franchisor's expertise to reduce the franchisee's risk of business failure or to enhance the franchisee's chances of success (the dependence factor); and second, the degree to which the franchisee needs the franchisor's advice and assistance (the reliance factor).[7]

The Interpretive Guides discuss dependence and reliance as closely related concepts, but with different emphases. Dependence relates to the franchisor's contribution to the relationship, in terms of expertise, training, advice, and business regimen. Access to a franchisor's guidance and expertise allows a novice to enter a business farther along on the learning curve. Reliance, on the other hand, relates to the franchisee's need for the franchisor's expertise and assistance. An inexperienced, unsophisticated prospect quite likely needs the franchisor's controls and assistance to operate the business successfully. Conversely, a person experienced in the business who already knows the industry's intricacies and appreciates its risks needs less help from the franchisor to succeed.[8]

The Interpretive Guides assign the dependence and reliance factors no relative weight. However, close attention to FTC Informal Staff Advisory Opinions[9] that analyze the franchise definition's second element reveals that franchisor contribution factors (dependence factors) receive weightier consideration than franchisee need factors (reliance factors) when the staff is rationalizing a decision that significant control or assistance exists. Conversely, reliance issues receive greater stress when the staff decides that significant control or assistance is absent.

Advisory Opinions in which the staff has detected the presence of significant control or assistance focus almost entirely on ways the franchisor brings value to the relationship. These opinions begin by recapping elements of the franchisor's contract or policy statements that describe services the franchisor provides and controls it imposes. They proceed to point out how the franchisor's controls and services measure up against the elements of control and assistance that the Interpretive Guides identify as inherently significant. (The list of fundamental controls encompasses site approval for unestablished businesses, site design or appearance requirements, hours of operation, production techniques, accounting practices, personnel policies and practices, promotional campaigns requiring franchisee participation or financial contribution, restrictions on customers, and location or sales area restrictions. The fundamental assistance list embraces formal sales, repair, or business training programs; accounting systems; management, marketing or personnel advice; site selection; and furnishing a detailed operating manual.[10])

Usually, the opinions quote the Interpretive Guides for the proposition that the presence of any element of fundamental control or any element of fundamental assistance "would suggest the existence of 'significant control or assistance.'"[11] After identifying one or more points at which the franchisor's contributions match the Interpretive Guides' lists, the opinions conclude with an observation that the franchisor's contribution is sufficient to create franchisee dependence on the franchisor. The inquiry ends at this point; no analysis of the franchisee's need to rely on the franchisor's guidance or expertise follows.

Advisory Opinions that result in a finding of no significant control or assistance follow a different analytical pattern. Rather than emphasizing the franchisor's contribution to the relationship, these opinions focus primary attention on factors that negate a franchisee's need for the franchisor's contribution. They emphasize facts that highlight the franchisee's experience and the degree of independence it retains from the franchisor's influence, while downplaying or ignoring facts that might demonstrate significant control or assistance in other situations.

These opinions also scrutinize the elements of franchisor control and assistance under a different microscope. Instead of demonstrating franchisee dependence by citing the Interpretive Guides' lists of significant controls and assistance and then noting points of intersection between the lists and the franchisor's contributions, they take another tack. They cite the Interpretive Guides for the proposition that "in order to be deemed 'significant' the controls or assistance must be related to the franchisee's entire method of operation."[12] The opinions then show how elements of discretion and independence that the franchisee retains preclude the franchisor's contributions from permeating the franchisee's whole operation. To contrast the two approaches, Advisory Opinions that find the definition's second element satisfied home in on the presence of *any* element of significant control or assistance; those that find the second element absent insist that the franchisor's contribution must permeate the franchisee's *entire* operation.

Two lines of Advisory Opinions illustrate how these divergent patterns of analysis play out. *United States Solar Industries, Inc.*[13] typifies opinions in which the staff finds a significant franchisor contribution present. In this opinion, the staff quotes from an advertisement in which the franchisor promises technical and sales training to prospective distributors. Citing the Interpretive Guides' lists of fundamental controls and assistance as authority, the staff concludes that the combination of technical training and promotional assistance is sufficient to indicate the presence of significant assistance. The opinion contains no discussion of the distributors' prior experience or the complexion of a typical distributor's operations and absent from the opinion is an analysis of franchisee reliance.

The staff followed the same approach in *Advisory Opinion* 96-1.[14] That opinion involves dealerships for components used in the construction of log cabins. The opinion states that the manufacturer of the components planned to provide marketing materials, protected territories, engineering consultation and sales leads, among other items of assistance. Without extensive review or discussion of relevant authority, the staff simply concludes that "[t]his type of assistance is sufficient to trigger coverage by the Franchise Rule." Like *United States Solar Industries*, *Advisory Opinion* 96-1 contains no discussion of a dealer's need for, or reliance on, the manufacturer's expertise. The same basic pattern of analysis, supporting the same result, appears in *International Consumers Club*,[15] *Travelhost Magazine, Inc.*,[16] *Advisory Opinion* 94-7,[17] *Advisory Opinion* 95-5,[18] and *Advisory Opinion* 96-3.[19]

The reliance factor moves to the forefront, however, in cases where the franchisor targets its program to experienced operators who will exercise a substantial measure of independence in the way they operate their businesses. In those instances, the absence of compelling need for the franchisee to rely on the franchisor's contribution to the relationship is the factor that supplants the dependence factor. Several Advisory Opinions illustrate this shift of emphasis.

Advisory Opinion 94-6 concerns a restaurant chain's plan to sell existing units to experienced restaurant operators. The fact statement indicates that buyers will be obligated to operate under the seller's trade name, to use some of its recipes, to comply with the seller's quality standards in preparing the recipes, and to comply with the seller's sanitation standards. The buyers can operate, manage, and market the restaurants in all other aspects as they choose.

In *Advisory Opinion* 94-6 the staff reiterates the Interpretive Guides' list of significant controls but merely as a predicate for its point of primary emphasis—the limited importance of the seller's controls to potential buyers. Because qualified buyers possess prior experience in the restaurant industry and retain discretion over crucial elements of their restaurant operations, the staff has concluded that the arrangement does not involve significant control. To minimize the importance of the franchisor's contribution in this situation, the staff highlights this statement from the Interpretive Guides:

> [I]t should be emphasized that in order to be deemed 'significant' the controls or assistance must be related to the franchisee's entire method of operation - not its method of selling a specific product . . . which represent[s] a small part of the franchisee's business. Controls or assistance directed to the sale of a specific product which ha[s], at most, a marginal effect on a franchisee's method of operating the entire business will not be considered in determining whether control or assistance is 'significant.'[20]

Interestingly, the staff does not even broach the issue of significant assistance, the paramount concern in the *United States Solar Industries* line of opinions.

The staff employs similar reasoning in two Advisory Opinions that involve software licenses. *Advisory Opinion* 94-9[21] relates to an educational software program the developer proposed to license to the operator of a chain of learning centers. The opinion observes that the licensor's role is limited to teaching learning center employees how to use the software and to maintaining and supporting the software program. The licensor proposes to exercise no control over the operation or management of the learning centers themselves, nor to provide any assistance relating to the learning center's operation or management. Under these circumstances, the staff elevates reliance over dependence and concludes that the program does not satisfy the franchise definition's second element. In the staff's view:

> Limited forms of assistance such as these appear to be tangential to the overall operation of a learning center. Moreover, you note that the owner of the learning centers is experienced in the sale of computer hardware and training services to schools. Thus, the learning center owner neither intends to rely on your client in operating his business, nor expects to reduce his risk by entering into the license arrangement.[22]

The staff reaches a similar conclusion in *Advisory Opinion* 95-1,[23] concerned with distributorships selling medical and office supply software. The fact statement indicates that the software licensor requires distributors to attend a training class and offers them optional sales and marketing assistance. The only restriction the licensor imposes on the distributors' marketing is a prohibition against their selling to another distributor's customers. Observing that typical distributors will be seasoned salespeople who will not rely on the licensor for basic sales training or organizational support, the staff concludes that the distributorships do not qualify as franchises. The staff's analysis uses the Interpretive Guides' list of fundamental controls to illustrate the relative lack of importance of the franchisor's contribution to the relationship. Its discussion focuses primarily on the substantial degree of independence distributors enjoy.

The FTC Advisory Opinions elevate reliance factors over dependence factors.

The most interesting opinion in this line of decisions is *Advisory Opinion* 95-8.[24] That opinion involves the relationship between a hotel owner and the Meridien hotel management company under a hotel management contract the parties planned to modify. Under the modified arrangement, the hotel owner assumes responsibility for the hotel's routine operations and management functions. However, the hotel continues to operate under the Meridien name, to participate in Meridien's reservation system and chain advertising plan, and to receive marketing and sales assistance from Meridien, subject to the owner's veto power. Also, Meridien retains the right to terminate the arrangement if the owner operates the hotel in a manner inconsistent with Meridien's quality standards.

Analyzed in light of the Interpretive Guides' lists of elements of significant control and assistance, Meridien's contributions appear to be inherently significant to the operation of a hotel. Were the components of its controls and assistance the only pertinent facts, an observer might expect the staff to position *Advisory Opinion* 95-8 within the *United States Solar Systems* line of opinions and conclude that a franchise exists. In point of fact, the staff notes that:

> The Hotel owner . . . will have final approval over Meridien's sales and marketing activities. Moreover, the Hotel owner is sophisticated having fully participated in the day-to-day operation and financial decisions affecting the Hotel during the fifteen year period in which Meridien has controlled all operational and management functions of the hotel. The owner understands how the Hotel has been marketed and how the Meridien reservation system works. Further, the Hotel owner contemplates assuming even more control over the operation of the Hotel than it exercised under its previous agreement with Meridien. Accordingly, it does not appear likely that the owner is relying upon Meridien's superior expertise in order to be successful.[25]

The staff gives overarching significance to the hotel owner's prior experience to conclude that the arrangement does not involve the second definitional element of a franchise.

To restate the themes in this line of Advisory Opinions, the staff elevates reliance factors over dependence factors to support a conclusion that significant control or assistance is absent by focusing on facts that demonstrate: (1) the franchisee's independence from franchisor control with respect to material aspects of operations and management; (2) the extent of the franchisee's experience in the same or an allied industry; and (3) the tangential relationship between the franchisor's program and the franchisee's overall enterprise.

These themes have important practical bearing on the way co-branding partners can structure their alliances to avoid pre-sale franchise regulation. As *Advisory Opinion* 95-8 demonstrates, a large enough measure of franchisee experience and independence can counterbalance substantial franchisor contributions. The second and third themes—franchisee experience and tangential impact—also run through another avenue of regulatory relief: the fractional franchise exemption. The literature relating to the exemption provides further clarification of the scope and function of these reliance factors. Consequently, a survey of the fractional franchise exemption will precede consideration of the practical implications of franchisee reliance.

The Franchise Rule's Fractional Franchise Exemption

The Franchise Rule provides that fractional franchises are exempt from regulation.[26] The Franchise Rule defines a fractional franchise as:

> any relationship . . . in which the person described therein as a franchisee, or any of the current directors or executive officers thereof, has been in the type of business represented by the franchise relationship for more than 2 years and the parties anticipated, or should have anticipated, at the time the agreement establishing the franchise relationship was reached, that the sales arising from the relationship would represent no more than 20 percent of the sales in dollar volume of the franchise.[27]

The fractional franchise exemption and the second element of the franchise definition are first cousins. According to the Franchise Rule's Statement of Basis and Purpose, "a 'fractional franchise' is only a specific example of a situation in which the producer does not exercise 'significant control' over, or give 'significant assistance' to the distributor."[28] The exemption applies in situations when:

> The franchisee's experience reduces his dependence on the expertise of the franchisor and reduces the ability of the franchisor to mislead the franchisee through incomplete or inaccurate disclosure. Further, because at least 80% of its sales are derived from other products[29] . . . the franchisee is not substantially dependent on the sales of the franchised product for his own success.[30]

The fractional franchise definition contains two essential elements: the franchisee or its management must have substantial experience in the same or a related line of business; and projected sales of the franchisor's products or services by the franchisee may not exceed 20 percent of the franchisee's total sales.

Although comparatively straightforward, the definition raises several interpretive questions, including the following:

- What activities qualify as "the type of business represented by the franchise relationship"?
- How literally should the phrase "directors or executive officers" of the franchisee be interpreted?
- Once acquired, can the relevant business experience become stale and lose its vitality for purposes of the exemption?
- How should alliance partners interpret "sales arising from the relationship" and "sales in dollar volume of the franchise" for purposes of calculating the 20 percent limitation?

The Interpretive Guides adopt a comparative approach to the "type of business" question. They state that a qualifying business may either be "the same business selling competitive goods, or . . . a business that would ordinarily be expected to sell the type of goods to be distributed under the franchise."[31] The Statement of Basis and Purpose shares this view, but lends additional perspective with these observations:

> Whether a prospective franchisee will have "been in the business represented by the franchise" will depend largely on the degree to which his previous experience is likely to be transferable to the new product or service, an inquiry likely to vary by the type of franchise involved.[32]

Also, "the franchisee in a fractional franchise will usually have . . . familiarity with the costs, profits, and potential problems of distributing similar goods . . . "[33]

These statements indicate that the answer to the "type of business" question in a particular situation turns on the franchisee's ability to comprehend and appreciate the franchised business' risks and rewards, based on actual management experience. To date, the staff has been asked to apply these somewhat amorphous standards to five situations. The staff reached a predictable result in two situations but the other three merit closer attention.

Advisory Opinion 94-4[34] relates to a health screening system the developer planned to license to hospitals, HMOs, physical therapists, and other health care professionals. The staff agreed that health care professionals are likely to be familiar with health screening services and therefore satisfy the exemption's experience requirement. It came to the opposite, but equally predictable, conclusion in *Advisory Opinion* 95-10[35] which pertains to vending machines. The question posed in that opinion is whether a law firm that purchases and operates a vending machine in its own offices for two years will then qualify to distribute the same type of vending machines to other businesses. The staff answered in the negative, reasoning that operation of vending machines provides no experience in distributing them.

Advisory Opinion 94-8[36] presents the "type of business" issue in a question of first impression: whether affiliation programs in which franchisees lose their identities as independent business people can qualify for the fractional franchise exemption? This opinion involves a conversion franchise program for limousine services that the franchisor offers only to people "who already have successfully operated a chauffeur driven business for at least five years." The staff concedes that this experience enables chauffeurs to understand the risks and rewards inherent in a limousine service business, but insists this understanding is insufficient to satisfy the fractional franchise exemption's experience requirement. In the staff's view, because franchisees lose their identities as independent business people and become totally dependent on the franchisor's business system and operating methods, they also need to understand the risks associated with a franchisee's subservient role. Until they experience the franchisee's role first hand, they lack the kind of experience the fractional franchise exemption contemplates.

The staff addressed a similar situation in *Advisory Opinion* 96-2[37] concerning an affiliation program a national real estate brokerage firm offers to local brokers. As part of its analysis, the staff examines the difference between an affiliation arrangement and a product or service line extension, noting that:

> In an affiliation arrangement . . . the business grows not by adding product lines or new services, but by expanding its traditional market. In that respect, an affiliate is analogous to a conversion franchise, where an existing business converts to a franchise . . . to tap the franchisor's business experience.[38]

Recognizing that this emphasis on the franchisor's contribution to the relationship (a dependence factor) potentially conflicts with the no-reliance rationale underpinning the fractional franchise exemption, the staff treads carefully in extending the exemption's availability to affiliation programs. It adopts these standards:

> In analyzing whether an affiliation arrangement may qualify for the fractional franchise exemption, we will be guided by several considerations. . . . [W]e will consider whether the franchisee is experienced enough to understand the risks that will likely arise when switching from an independent business to an affiliated business. We will also consider the practical and contractual impediments that may prevent the franchisee from disengaging from the affiliation relationship. In that regard, we will examine such factors as whether the affiliate retains its own goodwill and its own client base, whether the affiliate has other sources of income, and the extent to which the affiliate is subject to covenants not to compete or other post-term restrictions.[39]

The staff's willingness to give credence to the real estate broker's experience, but not the limousine driver's experience, can be explained by a notion that appears in *Advisory Opinion* 95- 8. In this opinion, the staff emphasizes the hotel owner's business sophistication and its ability to understand the complexities of a hotel's operation.[40] The inference is that the value the staff places on a franchisee's experience depends, in part, on the level of the franchisee's sophistication. The greater the level of sophistication, the more readily transferable the franchisee's prior experience will be to a similar business or to a variation of the business in which the franchisee formerly engaged.

Although sophistication serves to enhance the value of a franchisee's experience, no amount of sophistication can substitute for actual experience. The staff stresses this lesson in its fifth fractional franchise opinion, *Advisory Opinion* 97-1.[41] This opinion concerns a back rehabilitation system the developer planned to license to two classes of licensees: health care entities (such as hospitals and clinics) that have offered rehabilitation services for at least two years; and health care entities that have no direct experience with physical therapy or rehabilitation services but would presumably understand the risks and rewards associated with these services. The staff finds the fractional franchise exemption available for the first category of licensees, but not the second. In discussing the relevance of sophistication, the staff states:

> [T]he fractional franchise exemption is not the equivalent of a sophisticated investor exemption to the Rule. Rather, the exemption is available only in instances where franchisees are sophisticated precisely because of their actual experience with the particular goods or services, or similar goods or services, being offered through the franchise arrangement.[42]

Turning to the next issue, the fractional franchise definition indicates the two-year experience requirement may be satisfied by the franchisee directly, or may be imputed from experiences the franchisee's current directors and executive officers have accumulated.[43] The Interpretive Guides note that directors and officers must have gained their experience at the management level.[44] However, neither the FTC nor its staff has addressed several other questions about the implications and limitations of the exemption's use of "directors or executive officers."

For example, the definition provides no guidance as to whether general and limited partnerships, limited liability companies, and other types of non-corporate business entities can qualify for the exemption on the basis of their management's experience. If the FTC intended "directors or executive officers" as a shorthand way to indicate a level of seniority and not as a restriction on entity eligibility, these titles can be read expansively to include general partners, managing directors, and other senior executives of non-corporate entities. Nothing in the FTC's pronouncements reveals a policy against free access to the exemption by non-corporate business entities and there is certainly no conceptual reason why they should not benefit on the same footing as corporations.

The definition's experience element also leaves open more substantive questions that have less predictable answers. For example, may a host appoint a director or hire an executive in anticipation of forming an alliance that would not have otherwise qualified for fractional franchise treatment? Does the correct answer depend on whether the host initiates the move or the guest suggests it? Can the guest franchisor recommend that one its own executives serve on the host's board? Must the experienced person be appointed or hired in time to give the host substantive counsel and advice about the franchise opportunity or must the host's management even consult with the qualified individual during negotiations with the guest? Will the host's qualification for the exemption be impaired if all its directors and officers with the requisite experience resign soon after the parties embark on their alliance?

In the absence of authority to the contrary, the answers to these questions should depend on whether a particular maneuver effectively enhances a host's ability to comprehend and appreciate the franchised business' risks and rewards. If the appointment of an experienced director or executive provides a host with the necessary comprehension from an objective, unbiased perspective, the appointment's timing and motivation, as well as the guest's involvement in the individual's recruitment, should be irrelevant.

The fractional franchise exemption does not indicate whether the two-year experience requirement is subject to a freshness standard that weeds out people with outmoded experience. The Interpretive Guides indicate that qualifying experience may have been gained "at any time in the past."[45] Whether this statement continues to represent the FTC's position is open to question. When the FTC adopted the Interpretive Guides in the late 1970s, technology became obsolete less rapidly than today and businesses evolved more slowly. If the FTC revisits the issue, it might adopt a position similar to that in the new California experienced franchisee exemption which requires that the relevant experience be acquired within the last seven years.[46] The staff may have a similar standard in mind. In *Advisory Opinion* 94-4 the staff notes that licensees of the health screening system "are already familiar with health screening services and . . . are currently providing such services."[47] The latter statement would be redundant unless the staff considered timeliness a relevant standard.

A fourth set of interpretive questions relates to the meaning of "sales arising from the relationship" and "sales in dollar volume of the franchise" for purposes of calculating the 20 percent limitation. The Interpretive Guides indicate that "sales arising from the relationship" refers to the gross revenues the franchisee will derive from selling the franchisor's products or services and that "sales in dollar volume of the franchise" refers to the franchisee's total gross sales.[48]

In determining both amounts, alliance partners must project the host's financial performance into the "reasonably foreseeable future" which the FTC interprets as "a period of at least 1 year after the franchisee begins selling the goods or products involved in the franchise."[49] Thus, the 20 percent calculation involves a three-step process: (1) projecting the host's sales of the guest's products or services for at least a year from the date the relationship begins (longer, if the parties decide that twelve months does not constitute a representative period); (2) projecting the host's total gross revenues for the same period (including revenues from the guest's products or services); and (3) dividing the first amount by the second. The exemption depends on reasonable anticipation; the guest franchisor will not lose the exemption's benefits if the parties make their projections in good faith.[50]

Practical Application of the Dependence and Reliance Concepts

The fractional franchise exemption establishes objective, bright-line standards for determining whether the Franchise Rule's requirements apply to a particular co-branding alliance. A dependence/reliance analysis involves more subjective, fluid standards. In both cases, the host's experience and the contribution of the guest's products or services to the host's revenues are pertinent areas of inquiry. The table on this page shows the possible combination of circumstances that can exist in relation to these inquiries.

In combination, boxes A and C describe a situation that satisfies the fractional franchise exemption's standards. If a proposed alliance fits within these standards, or can be adjusted to satisfy them without distorting the arrangement's business or economic structure, guest and host can proceed to negotiate and implement their relationship without further regard for the Franchise Rule.

Boxes B and D combine to illustrate the opposite end of the spectrum. An alliance with the characteristics these boxes describe clearly fails to satisfy the exemption's standards. They also exemplify a situation in which the *United States Solar Industries* line of Advisory Opinions would tilt a dependence/reliance analysis toward a finding of dependence. An alliance that exhibits these characteristics probably cannot escape Franchise Rule coverage unless the guest is willing to forgo a fee.

The remaining combinations present cases in which a careful dependence/reliance analysis may be successful. A situation that appears tainted on the surface may, under closer scrutiny, display characteristics the FTC's staff has highlighted to elevate reliance factors over dependence factors and to establish an absence of significant control and assistance. As indicated previously, these characteristics include: (1) the degree of the host's independence from the guest's control with respect to material aspects of operations and management; (2) the extent of the host's experience in the same or an allied industry; and (3) the tangential relationship between the guest's program and the host's overall enterprise. The host's sophistication also counts in assessing the relevance of the host's experience.

Boxes B and C describe a situation in which the guest's concept will impact the host's revenues by less than 20 percent but the host does not satisfy the fractional franchise exemption's two-year experience requirement.

In this situation, alliance partners are well advised to explore three further lines of inquiry. First, is relief from pre-sale regulation important enough to justify the host's hiring an executive or appointing a board member with the required experience? If it is, the partners can qualify for the fractional franchise exemption by adding the required expertise to the host's organization.

Second, by how much less than 20 percent are the guest's products or services likely to impact the host's revenues? If the projected contribution is modest and the host can demonstrate some measure of experience in the guest's industry, the alliance may still escape coverage on the grounds that the overall arrangement is tangential to the host's operations. For

A Experienced Host	B Inexperienced Host
C Less Than 20% of Sales	D More Than 20% of Sales

example, an alliance that involves a host with one year's relevant experience but an expected revenue impact of only 5 percent may find shelter under the dependence/reliance analyses *Advisory Opinions* 94- 6[51] and 94-9[52] contain.

Third, does the host's management have enough business acumen and sophistication to construct an accurate picture of the alliance's risks and rewards on the basis of its experience? If the answer is yes, the host's sophistication may be adequate to bolster the value and utility of its experience to a qualifying level. *Advisory Opinion* 97-1[53] teaches that a host must possess some measure of actual experience in the guest's industry (or one with parallel risk/reward parameters). On the other hand, *Advisory Opinions* 95-8[54] and 96-2[55] imply that depth of sophistication in disciplines such as finance, accounting, marketing, and general management principles may be adequate to offset a shortage of industry-specific experience. To date, the FTC's staff has not had occasion to comment on the correlation between sophistication and experience. Therefore, the amount of inexperience that sophistication can offset remains uncertain. Presumably, companies that enjoy economic size, organizational depth, and longevity more likely will benefit from sophistication than start-up or development stage hosts.

Boxes A and D combine to describe the fourth set of circumstances in which a dependence/reliance analysis might prove fruitful.

This is the situation in which the host has abundant experience in the guest's line of business, but the guest's products or services will count for more than 20 percent of the host's projected revenues. In this situation, the parties can be guided by the rule that the greater the host's actual experience in the same or a closely allied business, the less important the impact of the guest's products or services on the host's revenues. Further, the value of the host's actual, direct experience increases in proportion to its general business sophistication. No case or Advisory Opinion has fixed the upper limits of this rule's utility, but *Advisory Opinions* 94-6[56] and 95-8[57] imply that the limit may be quite high. In fact, the management company's services accounted for substantially all of the hotel owner's revenues under the facts presented in *Advisory Opinion* 95-8 yet the FTC's staff concluded that substantial control and assistance were absent from the relationship.

The situations profiled in the preceding paragraphs are more likely to escape Franchise Rule coverage if other limiting factors are present. With no bright-line tests to rely on, the cumulative effect of pertinent embroidery can prove decisive. The following are observations alliance partners and their counsel might consider.

- It is easier to justify an exclusion for a concept that is operationally simple than for a concept that is operationally complicated. Generally, the less training and operations support the guest offers or the host needs, the stronger the argument that the relationship does not involve significant guest controls or assistance. To achieve maximum advantage, guests should tailor their co-branding packages to eliminate redundant controls and assistance a particular host does not need or want. In all cases, they should eliminate as many of the controls and services that appear on the FTC's lists of fundamental controls and assistance as possible, preferably all of them.
- The host must retain independence in the way it operates its core business. A guest should insist on dictating standards only for activities that relate directly to operation of its concept. The host should retain complete control over personnel, compensation, accounting, and other key management policies. The less intrusive the guest's rules and regulations, the stronger the argument for host independence.
- Preferably, both parties should retain discretion to dissolve the alliance without economic penalty if either decides the relationship no longer serves its interests. The guest should not bind the host to a post-term covenant against competition, unless a restriction on post-term competition appears to be the only effective way to shelter trade secrets or to inhibit fickle behavior by the host. This is a subtle, but important, point *Advisory Opinion* 96-2[58] raises (this opinion considers real estate brokerage affiliations).
- The agreement that governs the alliance should reinforce the parties' intention not to create a franchise relationship. A trademark license is an essential ingredient of many co-branding alliances. The agreement, therefore, may convey such a license. However, the guest should avoid licensing its business system as a whole, as it would in the context of a franchise. A simply phrased grant of a limited right to use the guest's operation's procedures or merchandizing techniques will suffice. The agreement should also preserve the preeminence of the host's trademarks and trade dress in the combined enterprise. For example, limiting the surface area of signs that feature the guest's mark to not more than 30 percent of the surface area of signs that depict the host's mark. Further, the agreement should expressly disclaim the guest's intention or obligation to provide any services or to impose any controls that go beyond the bare minimum required to support the host's offering of the guest's products or services in an operationally sound fashion.

The situations this section describes involve two-party alliances in which the host will operate the units in which the guest's concept appears and in which the guest itself will provide all of the training and operations support the project entails. If alliance partners chose a more complex structure, they will need to repeat the dependence/reliance analysis for each additional level of participation they involve.

Conclusion

Avoiding Franchise Rule compliance will hold attraction for alliance partners as co-branding becomes an increasingly pervasive feature of franchising's landscape. The effort to identify and perfect an exemption or an exclusion will prove especially rewarding to guests who want to reduce their transaction costs, increase flexibility in negotiating and structuring an alliance, or defuse hostility from hosts who lack familiarity and sympathy with the legal constraints that apply to franchising. The concepts of dependence and reliance provide keys that franchise counsel can often use to help their clients claim these rewards.

This article's observations and recommendations are not intended as recipes that counsel can use uncritically to concoct an escape from pre-sale regulation. Instead, it presents analytical tools counsel can use to rationalize and refine an ambiguous fact situation as a prelude to requesting an Advisory Opinion. It also suggests a vocabulary counsel can use to avoid extraneous issues in framing their Advisory Opinion requests.

The article's observations and recommendations also are not intended as panaceas for the pains of pre-sale regulation. Not every alliance can escape regulation. Some involve transfers of novel information and unique procedures that necessarily create dependence. Others involve guests who refuse to relinquish tight control over any outsider who operates under their trade names. Despite these countervailing factors, enough co-branding alliances can benefit from the exercises this article suggests to justify the time and energy required to perform them.

Endnotes

1. *See, e.g.*, Cantor, *Combination Franchising*, 20th IFA Legal Symposium (May 1987); Lowell and Kirsch, *Dual Branding: The New Franchising Phenomenon*, Leader's Franchising Business and Law Alert (Nov. & Dec. 1995); G. Cannon, *Hot Franchise Topics - Co-Branding*, State Bar of Texas Intellectual Property Law Institute, Mar. 1996; Rudnick et al., *Dual Branding and Combination Franchising: Issues for Host and Tenant Franchise Networks*, 29th Int'l Franchise Ass'n Ann. Legal Symp., May 1996; Hurwitz, *Co-Branding: Managing Franchise Brand Associations*, 20 OKLA. CITY U. L. REV. 373 (Summer/Fall 1995); Koch and Minami, *Choosing a Running Mate: Lessons from Dual-Branding in the Food Service Industry*, 1996 Annual Forum, ABA Forum on Franchising; Costello, *Baskin Donuts: Hidden Pitfalls in Co-Branding*, LEADER'S FRANCHISING BUSINESS AND LAW ALERT (July 1997).

2. The official title of the FTC's trade regulation rule on franchising is "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures," 16 C.F.R. ¶¶ 436.1-436.3 (August 19, 1997). Commentators commonly refer to it as the "Franchise Rule." The Franchise Rule appears at 44 Fed. Reg. 31170 (May 31, 1979) and is reproduced at Bus. Franchise Guide (CCH) ¶ 6080 et seq.

3. Many of the ideas in this paper derive from a workshop Kim A. Goodhard and I conducted at the 1995 ABA Forum on Franchising. I gratefully acknowledge Ms. Goodhard's contribution to the analyses that appear in this article.

4. 16 C.F.R. ¶ 436.2(a); Bus. Franchise Guide (CCH) ¶ 6162. The entire definition reads:

"The term 'franchise' means any continuing commercial relationship created by any arrangement or arrangements whereby:

(1)(i)(A) A person (hereinafter 'franchisee') offers, sells, or distributes to any person other than a 'franchisor' (as hereinafter defined), goods, commodities, or services which are:

(1) Identified by a trademark, service mark, trade name, advertising or other commercial symbol designating another person (hereinafter 'franchisor'); or

(2) Indirectly or directly required or advised to meet the quality standards prescribed by another person (hereinafter 'franchisor') where the franchisee operates under a name using the trademark, service mark, trade name, advertising or other commercial symbol designating the franchisor; and

(i)(B)(1) The franchisor exerts or has authority to exert a significant degree of control over the franchisee's method of operation, including but not limited to, the franchisee's business organization, promotional activities, management, marketing plan or business affairs; or

(i)(B)(2) The franchisor gives significant assistance to the franchisee in the latter's method of operation, including, but not limited to, the franchisee's business organization, management, marketing plan, promotional activities, or business affairs; provided, however, that assistance in the franchisee's promotional activities shall not, in the absence of assistance in other areas of the franchisee's method of operation, constitute significant assistance; or

[Business Opportunity definition omitted]; and

(2) The franchisee is required as a condition of obtaining or commencing the franchise operation to make a payment or a commitment to pay to the franchisor, or to a person affiliated with the franchisor."

5. 16 C.F.R. ¶ 436.2(a)(i)(B)(1), (2); Bus. Franchise Guide (CCH) ¶ 6162.

6. Officially titled, "Interpretive Guides to Franchising and Business Opportunity Ventures Trade Regulation Rule." They appear at 44 Fed. Reg. 49966 (August 24, 1979) and are reproduced at Bus. Franchise Guide (CCH) ¶ 6200 et seq. They are referred to and cited from this point forward as the "Interpretive Guides."

7. Interpretive Guides, 44 Fed. Reg. 49966 (August 24,1979); Bus. Franchise Guide (CCH) ¶ 6206.

8. *Id.*

9. Informal Staff Advisory Opinions issued by the FTC's staff are referred to and cited from this point forward as "*Advisory Opinions*."

10. Interpretive Guides, 44 Fed. Reg. 49966 (August 24,1979); Bus. Franchise Guide (CCH) ¶ 6206.

11. *Id.*

12. *Id.* "Method of operation" is a term the FTC developed to refer to "those areas of business operations that, in a conventional commercial relationship, would be within the discretion of the non-franchised distributor." Examples of the components of a business' method of operation include "business organization, hours of operation, format or design of the outlet, management, promotional activities, marketing plan, or business affairs." Statement of Basis and Purpose Relating to Franchising and Business Opportunity Ventures Trade Regulation Rule, 43 Fed. Reg. 59614 (Dec. 21, 1978), Ch. V, text at note 41; Bus. Franchise Guide (CCH) ¶ 6350.

13. Bus. Franchise Guide (CCH) ¶ 6411 (April 25, 1980).

14. Bus. Franchise Guide (CCH) ¶ 6476 (April 12, 1996).

15. Bus. Franchise Guide (CCH) ¶ 6413 (May 5, 1980).

16. Bus. Franchise Guide (CCH) ¶ 6444 (March 2, 1989).

17. Bus. Franchise Guide (CCH) ¶ 6463 (October 18, 1994).

18. Bus. Franchise Guide (CCH) ¶ 6470 (April 4, 1995).

19. Bus. Franchise Guide (CCH) ¶ 6478 (July 19, 1996).

20. *Id.*

21. Bus. Franchise Guide (CCH) ¶ 6465 (December 20, 1994).

22. *Id.*

23. Bus. Franchise Guide (CCH) ¶ 6466 (January 31, 1995).

24. Bus. Franchise Guide (CCH) ¶ 6473 (August 29, 1995).

25. *Id.*

26. 16 C.F.R. ¶ 436.2(a)(3), Bus. Franchise Guide (CCH) ¶6162.

27. 16 C.F.R. ¶ 436.2(h), Bus. Franchise Guide (CCH) ¶6173.

28. Statement of Basis and Purpose Relating to Franchising and Business Opportunity Ventures Trade Regulation Rule, 43 Fed. Reg. 59614 (Dec. 21, 1978), Ch. V, note 81; Bus. Franchise Guide (CCH) ¶ 6350. This document is referred to and cited from this point forward as the "Statement of Basis and Purpose."

29. This statement implies that the fractional franchise exemption applies only to distributorships and other types of product franchises. *Advisory Opinion* 93-5, Bus. Franchise Guide (CCH) ¶ 6449 (April 2, 1993) confirms that the exemption applies to service franchises.

30. Statement of Basis and Purpose, Ch. V, note 83, Bus. Franchise Guide (CCH) ¶ 6350.

31. Interpretive Guides, 44 Fed. Reg. 49966 (August 24,1979); Bus. Franchise Guide (CCH) ¶ 6210.

32. Statement of Basis and Purpose, Ch. V, note 80, Bus. Franchise Guide (CCH) ¶ 6350.

33. *Id.*, text at note 83.
34. Bus. Franchise Guide (CCH) ¶ 6460 (May 12, 1994).
35. Bus. Franchise Guide (CCH) ¶ 6475 (December 8, 1995).
36. Bus. Franchise Guide (CCH) ¶ 6464 (December 21, 1994).
37. Bus. Franchise Guide (CCH) ¶ 6477 (May 20, 1996).
38. *Id.* Emphasis supplied.
39. *Id.*
40. Bus. Franchise Guide (CCH) ¶ 6473 (August 29, 1995).
41. Bus. Franchise Guide (CCH) ¶ 6481. No date of issuance is indicated.
42. *Id.*
43. Neither the Franchise Rule nor the FTC commentaries indicate whether the experiences of the franchisee, its directors, and its officers may be aggregated to satisfy the two-year requirement. The grammar of the fractional franchise definition argues against aggregation.
44. Interpretive Guides, 44 Fed. Reg. 49966 (August 24, 1979); Bus. Franchise Guide (CCH) ¶ 6210.
45. *Id.*
46. CAL. CORP. CODE ¶ 31106 (West 1996), Bus. Franchise Guide (CCH) ¶ 3050.282.
47. Bus. Franchise Guide CCH ¶ 6460 (May 12, 1994).
48. 44 Fed. Reg. 49966 (August 24, 1979); Bus. Franchise Guide (CCH) ¶ 6210. The staff misinterpreted "sales arising from the relationship" in *Advisory Opinion* 94-8, Bus. Franchise Guide (CCH) ¶ 6464 (December 21, 1994), discussed previously at note 37. That opinion addressed a program in which the franchisor required franchisees (chauffeurs with a minimum of five years' prior experience) to operate exclusively under its trade name and business system but charged royalties only on "incremental business." The franchisor defined incremental business as "business which exceeds the licensee's gross volume of business for the year prior to the execution of the license agreement." The staff reasoned that, because incremental business was projected to fall below 20 percent of a licensee's total revenue, the program satisfied the fractional franchise exemption's sales limitation requirement.
The revenue base for purposes of calculating royalties has no necessary relationship to the percentage of sales that arise from the franchise relationship. The pertinent inquiry is whether the franchisee can spread its financial risk by promoting products or services outside the relationship. In this case, the chauffeurs converted their existing businesses to the franchisor's system, thus becoming totally dependent on the franchisor's business system and operating methods. The staff should have concluded that 100 percent of their revenues qualified as "sales arising from the relationship."
49. Interpretive Guides, 44 Fed. Reg. 49966 (August 24, 1979); Bus. Franchise Guide (CCH) ¶ 6210.
50. Interpretive Guides, 44 Fed. Reg. 49966 (August 24, 1979); Bus. Franchise Guide (CCH) ¶ 6210.
51. Bus. Franchise Guide (CCH) ¶ 6462 (July 25, 1996).
52. Bus. Franchise Guide (CCH) ¶ 6465 (December 20, 1994).
53. Bus. Franchise Guide (CCH) ¶ 6481. No date of issuance is indicated.
54. Bus. Franchise Guide (CCH) ¶ 6473 (August 29, 1995).
55. Bus. Franchise Guide (CCH) ¶ 6477 (May 20, 1996).
56. Bus. Franchise Guide (CCH) ¶ 6465 (July 25, 1994).
57. Bus. Franchise Guide (CCH) ¶ 6473 (August 29, 1995).
58. Bus. Franchise Guide (CCH) ¶ 6477 (May 20, 1996).