

Are Your Distributors Actually Franchisees?

Manufacturers generally believe that, absent a specific agreement, they may hire and fire distributors at will. Not so if the distributor persuades a court that the manufacturer and distributor are actually in a franchise relationship. Unfortunately, franchises are not limited just to fast food restaurants or businesses that present a common appearance to the public. Twenty-one states now have franchise statutes of general applicability.

These franchise statutes are of two generic kinds. One, exemplified by Wisconsin and New Jersey, defines a franchise as an agreement by which the franchisee is granted the right to distribute the goods or services of the supplier and there exists a “community of interest” in the distribution of those items. Wisconsin’s law defines a community of interest as “a continuing financial interest” between the supplier and distributor “in either the operation of the dealership business or the marketing of such goods or services.” The other variety of franchise statute, of which

GERALD G. SALTARELLI
JASON S. DUBNER

Indiana is an example, is equally amorphous. Under the Indiana statute, a franchise is an agreement by which the franchisee is granted the right to distribute the supplier’s products “under a marketing plan or system prescribed in substantial part by a franchisor,” and the operation of the franchisee’s business pursuant to such a plan is “substantially associated” with the franchisor’s trademark, service mark, or trade name. As one might imagine, these statutory definitions are difficult to apply to specific business relationships.

Whether a particular distribution arrangement qualifies as a franchise relationship is often debatable. Fortunately, fourteen states additionally require the payment of a “franchise fee” before the relationship will constitute a franchise. In general, a franchise fee may include any payment to the supplier other than for product purchased under the agreement. A supplier can thus avoid the problems associated with being labeled a franchisor in these states by ensuring that it does not require

its distributors to pay anything other than a bona fide wholesale price for product. In this context, the supplier must be alert to avoid indirect or disguised franchise fees. Payments for training, sales materials, manuals, and catalogues may be deemed to be disguised fees. Even payments for the right to use the supplier’s computer network, for example, could arguably constitute a franchise fee under certain states’ statutes. If the requisite fee is found, the court hearing the post-termination dispute may determine that a franchise relationship existed.

If the distributor is found to be a franchisee, the franchise statutes may offer the distributor certain protections against termination. For example, those statutes typically require that the supplier have “good cause” to terminate or not renew the relationship, or even just to “change the competitive circumstances” of the distributor. A change in competitive circumstances can result from simply altering a distributor’s territory or appointing additional distributors in its area. Many of the statutes require, prior to termination, that the supplier provide written notice of its intent to terminate or non-renew, or of an impending change in competitive circumstances. A supplier may also be required to allow the distributor sixty days in which to cure any cited performance deficiencies.

Suppliers naturally wish to avoid being held to a good cause standard. Good cause generally requires that the distributor’s performance or conduct be materially deficient in an objective, demonstrable way. A general belief that the distributor is not devoting sufficient attention to the supplier’s product line, or that some other distributor would be better in a given market, may not be sufficient.

In addition to general franchise laws, many states have industry-specific or equipment dealer protection statutes. These laws also cannot be ignored in the termination analysis because their vague language could conceivably be held to encompass everyday industrial products. For example, the California Equipment Dealers’ Act applies to “equipment” which is defined as “machines designed for or adapted and used for

agriculture, livestock, grazing, light industrial, and utility [use]. . . .” In this case, as with a number of other industry-specific state franchise statutes, there is little or no case law to assist the supplier in determining whether its product fits within the “light industrial” category. Some states dispense with the qualifier “light” and extend the protection of the equipment dealers’ statute simply to distributors of “industrial” products. Like the general franchise statutes, these equipment dealer laws often require good cause for termination or non-renewal.

Obviously, general franchise statutes and the equipment dealer laws provide a potentially powerful weapon to distributors facing termination or non-renewal. What should the supplier do?

First, design the distribution arrangement to avoid any indicia of franchise status. To the maximum extent possible, omit terms that give you control over the distributor or its method of business. Similarly, ensure that you are not in any way exacting payments from the distributor that later may be characterized as a franchise fee. In addition, although courts may choose to ignore statements in distribution agreements that specifically disclaim the existence of a franchise or that allow the manufacturer to appoint additional distributors at will, it is worth considering including such terms in your agreement as well.

Second, conduct a pre-termination analysis to determine the chances that a franchise law will apply. As a general rule, the shorter the duration of your relationship with the distributor, the less the distributor is identified with you, the less dependent it is on your products, and the less control that you have over its method of conducting business, the greater the chance that a franchise relationship will not be found to exist.

Third, make sure that you analyze any industry-specific or equipment dealer protection statutes that may apply. In some states, equipment dealer statutes seem clearly aimed at specific industries or types of businesses. In others, like those described above, there may be a risk that the statute covers your distributor.

Fourth, even if you believe that your distributor is not a franchisee, consider whether you should comply with the requirements of the potentially relevant statute while not admitting that you are required to do so. In such instances, identify the deficiencies in the distributor’s performance, provide notice to the distributor, and specify the period in which the distributor must effectuate

a cure. Be as specific and as objective as possible, for if the distributor does not change its ways, you want to be able to demonstrate clearly and precisely how it failed.

Fifth, analyze the distributor’s incentive to take action in response to termination, non-renewal, or some other change in competitive circumstances. Many distributor terminations do not engender any serious response because the distributor is not dependent on the supplier’s products or can easily obtain a replacement line for the one just lost. The threat of retaliation will also be lessened if the change merely involves appointing additional distribution to the distributor’s territory, rather than termination. In other instances, however, the supplier’s products may constitute a significant part of the distributor’s business. In that case, termination might result in the closure of the distributor’s business. Consequently, in such situations, the supplier must exercise maximum care in analyzing the potential applicability of state franchise statutes and the risk that it may have to demonstrate good cause for its action.

Finally, use the potential application of a particular state franchise statute as an incentive to train your business people. Nothing can be more disturbing to a sales manager than learning that he must wait six months before adjusting his distribution network because of the potential legal implications associated with the contemplated termination. Armed with the knowledge that you may need him to be prepared to carefully document a targeted distributor’s objective deficiencies rather than simply making general allegations of poor performance, everyone in your organization will be better equipped to overcome the potential hurdles presented by certain state franchise acts. With a more educated and organized approach to restructuring your distribution network, even the potential of having your distributors classified as franchisees will not prevent your company from aggressively pursuing its preferred course of business.

Gerald G. Saltarelli is a partner and Jason S. Dubner is an associate with Butler Rubin Saltarelli & Boyd LLP, a Chicago litigation boutique. They specialize in competition law counseling and disputes and regularly advise manufacturers on distribution termination issues. The views expressed are personal to the authors.



BUTLER RUBIN
excellence in litigation™