

# GOVERNMENT REGULATION OF FRANCHISES

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**I. (§67.1) INTRODUCTION**

Various federal and state laws govern franchise transactions. Certain laws regulate the offer and sale of franchises, reflecting state and federal interests in protecting purchasers of franchises. Other laws, such as state franchise relationship laws, regulate franchise relationships and distribution methods.

State franchise laws usually require registration and prior disclosure of information to prospective franchisees in a manner similar to that required under state securities laws. The Oregon franchise law requires disclosure, but not registration, of franchise offers. ORS ch 650. The Federal Trade Commission franchise disclosure rule contains its own disclosure requirements but it does not require registration with any governmental agency. 16 CFR pt 436.

Other laws can apply in the franchising context and can be traps for the unwary. The lawyer should fully investigate them before helping a franchisor launch a franchise program. These laws include business opportunity laws, securities laws, state unlawful trade practices acts and anti-trust laws.

Comment: The Federal Trade Commission rule (“FTC rule”) describes federal legal requirements for *franchises* at 16 CFR part 436 and for *business opportunities* at 16 CFR part 437. The FTC rule was amended July 1, 2007 (with mandatory compliance beginning after July 1, 2008). References in this chapter 19 to the FTC rule are to the rule *as amended*.

Many growing businesses (and their lawyers) have been surprised to learn that they have inadvertently fallen under the purview of franchise or business opportunity laws. Numerous articles have been written about “hidden franchises.”

See, e.g., Lockerby, Lindsey and Spandorf, *When Are Distribution or Licensing Agreements Franchise Agreements?*, International Franchise Association 37<sup>th</sup> Annual Legal Symposium (May 2004 Program Materials); Clayman, *The Unintended Franchise: Beware of a Possible Wolf in Sheep's Clothing*, Franchising Bus L & Alert 1 (Sept 2001); Thomas J. Collin, *State Franchise Laws and the Small Business Franchise Act of 1999: Barriers to Efficient Distribution*, 55 Bus Law 1699 (Aug 2000).

## II. DEFINITION OF A FRANCHISE

### A. (§67.2) Introduction

Many state franchise laws have franchise definitions that are similar to the three-prong definition of a franchise under federal law. There are, of course, exceptions. These variations are often overlooked in a nationwide analysis under the three-prong test.

It is possible to meet a state's definition of a franchise and not fall within the franchise definition under federal law. The opposite scenario is also possible. If a business concept meets the franchise definition in any jurisdiction, then the franchisor must comply with the franchise laws of that jurisdiction. Compliance would likely include franchise disclosure requirements and may include franchise registration or exemption requirements in the case of most state franchise laws. *See* §§67.22–67.29.

### B. (§67.3) Federal Law

The FTC rule defines *franchise* as follows:

*Franchise* means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:

(1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute

goods, services, or commodities that are identified or associated with the franchisor's trademark;

(2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and

(3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate. 16 CFR §436.1.

Note: The FTC Rule's Statement of Basis and Purposes clarifies the franchise definition. Bus Franchise Guide (CCH) ¶6060 (July 1, 2007). For example, it clarifies that a franchise exists if the three definitional elements are met, even if the franchisor calls the relationship by another name. It also clarifies that a franchise exists if the franchisor *represents* that the relationship being offered has the definitional elements of a franchise, even if the franchisor later fails to perform as promised (e.g. the second prong is met even if the franchisor has authority to exert, such as by oral or written contract, but does not in fact exert, significant control or assistance).

For the second definitional element, significant controls over operations or promises of assistance may relate to:

- training programs;
- marketing assistance;
- site approval;
- location or sales area restrictions;
- hours of operation;
- types of products or services offered and how they are offered;
- personnel policies;
- accounting practices;
- providing a detailed operations manual; or
- other forms of control or assistance.

*See, e.g., Interpretive Guides to Franchising and Business Opportunity Ventures*

*Trade Regulation Rule*, 44 Fed Reg 49,966 et seq. (while these interpretive guides relate to the FTC rule before it was amended, the guides are referenced in the amended FTC rule's Statement of Basis and Purpose and are likely still relevant) and *Leonetti Furniture Manufacturing Co. v. Sealy, Inc.* (DC Ore 1990). (A license to manufacture beds and sleeper sofas did not constitute a "franchise" within the FTC franchise disclosure rule, since the licensor did not exercise a significant degree of control over the licensee through any marketing plan or system. The licensor had no control over the licensee's business hours or "style" of operation. The fact that the licensor had to meet manufacturing specifications did not transform the relationship into a franchise.)

Under the third prong of the franchise definition, franchise payments are not limited to direct franchise fees paid by a franchisee at the outset of the business. They may include "hidden" and indirect fees. They may include payments for advertising assistance and materials, royalty payments and fees for required training and other services if those payments are not determined to be an ordinary business expense. *See, e.g., Boat & Motor Mart v. Sea Ray Boats, Inc.* 817 F2d 573, 825 F2d 1285 (9<sup>th</sup> Cir. 1987) (A boat dealer's extensive advertising and its purchases of promotional materials satisfied the "franchise fee" requirement under California law.) In addition, payments for required purchases of equipment or inventory may constitute franchise fees. In particular, required purchases of "unreasonable" amounts of inventory and required purchases of inventory at prices exceeding the bona fide wholesale prices of those goods have been found to constitute franchise fees. *See, e.g., James v. Whirlpool Corp.* 86 F. Supp. 835 (ED Mo 1992) (The court, applying Michigan law, rejected the argument that the distributor's inventory purchase requirement amounted to a franchise fee because there was no showing that the inventory requirement was unreasonable.) and *Interpretive Guides to Franchising and Business Opportunity Ventures Trade Regulation Rule*, 44 Fed Reg 49,966 et seq.

Under the FTC rule, a sale is excluded from the scope of the regulation if the total required payments by the franchisee before and during the six-month period after the business opens do not exceed \$500. 16 CFR §436.8(a)(1).

Caveat: The six-month period under the FTC rule is not reflected in state franchise law definitions. The threshold amounts under the state laws vary. The

time period over which franchise fees are aggregated for purposes of the threshold amount also varies.

Caveat: The substance of the relationship controls over the form so that certain distributorships, license agreements, or marketing arrangements might fall within a statutory definition of *franchise*. See, e.g., *Cooper Distributing Co. v. Amana Refrigeration, Inc.* 63 F.3d 262 (3rd Cir 1995) (home appliance distributor constituted a “franchisee” under the New Jersey Franchise Practices Act); *Master Abrasives Corp. v. Williams*, 469 NE2d 1196 (Ind App 1984) (exclusive territorial rights to sell trademarked products), *overruled on other grounds*, *Enservco, Inc. v. Indiana Sec. Div.*, 623 NE2d 416, 425 (Ind 1993); *Corp v. Atlantic-Richfield Co.*, 726 P2d 66, 45 Wash App 563 (1986), *rev’d on other grounds*, 860 P2d 1015 (1993) (convenience store lease constituted franchise because percentage rent satisfied definition of franchise *fee*).

### C. (§67.4) Oregon and Other State Laws

Generally, the *franchise* definition in states that have enacted franchise laws is similar to the three-part FTC definition provided in Section 67.3, *supra*. See also The definition under Oregon’s franchise laws includes three-prongs and is similar to the FTC rule definition. ORS 650.005(4).

CAVEAT: While Oregon’s franchise definition is similar to the FTC definition, it is not identical. Lawyers should carefully compare these definitions. For example, under the Oregon franchise definition, the third prong is met if the franchisee must give to the franchisor “valuable consideration” for the right to become a franchisee. ORS 650.005(4)(c). However, the federal law specifically defines the minimum amount of payment(s) that meet this prong of the definition. See §67.3.

The laws of some states, such as New York and Connecticut, have a two-part definition of a franchise. These and other state-specific variations are often overlooked in a nationwide analysis under the federal three-prong test.

The payment of a franchise fee is a required element of a franchise under

most state franchise statutes (except, for example, Connecticut). Similar to the FTC franchise definition, under most state franchise laws, a franchise fee is considered any payment, or commitment to pay, for the right to do business as a franchisee. Most state laws have a minimum threshold amount for the franchise fee. If the franchise fees paid by the alleged franchisee do not reach this threshold, no “franchise” exists. The threshold amounts under the state laws vary. The time period over which franchise fees are aggregated for purposes of the threshold amount also varies. In a 1998 case particularly on point, involving the Illinois Franchise Disclosure Act, the U.S. Court of Appeals for the Seventh Circuit determined that a dealer’s payment of more than \$1,600 for parts and service manuals over the course of eight years satisfied the statute’s \$500 threshold fee. *To-Am Equipment Co. v. Mitsubishi Caterpillar*, 152 F3d 658 (7th Cir 1998), *aff’d* 953 F Supp 987 (ND Ill 1997).

Note: Even if a transaction does not qualify as a franchise under a particular state’s law or if the state has no franchise statute, coverage may exist under a business opportunity statute. *See* §§67.6–67.12. Lawyers involved in transactions with multi-state implications should review all potentially applicable laws. The CCH Business Franchise Guide is a convenient source of statutes and regulations relating to franchises and business opportunities and includes nationwide and international coverage.

#### **D. (§67.5) Exemptions**

The FTC rule contains various exemptions and exclusions to the definition of a franchise and the disclosure requirements and relationship restrictions. 16 CFR §436.8. The numerous state franchise laws also contain exemptions and exclusions. These differ from state to state but may include a large franchisor, a large franchisee, a sophisticated investor, a fractional franchise, an isolated transaction, or similar considerations. They are fully described, by jurisdiction, in the Business Franchise Guide (CCH).

### **III. TRAPS FOR THE UNWARY FRANCHISOR**

#### **A. (§67.7) Business Opportunity Statutes**

## **1. (§67.6) Generally**

Federal law governs the offer and sale of “business opportunities.” 16 CFR §437. In addition, almost half the states, but not Oregon, have business opportunity statutes. The FTC rule requires presale disclosures and prohibits making fraudulent claims (including a promise to make refunds when refunds are not forthcoming). 16 CFR §437.1. The FTC rule does not require registration, filing, or review of the disclosure documents, nor does it require the business opportunity seller to make financial assurances to its purchasers.

In contrast, state business opportunity laws often require that a seller register its offering with a state administrator before beginning to offer or sell the opportunity within the state. This requirement is always coupled with a presale disclosure obligation. Most states also require business opportunity sellers to post a specified bond, establish escrow accounts, or otherwise give financial assurance to the buyer that the seller will deliver on the promises made. All of this can be burdensome and expensive. Many states have minimum contract content requirements and prohibit certain types of contractual provisions.

NOTE: Some state franchise registration laws are drafted broadly enough to include some, if not all, business opportunity programs. Other states have real estate broker licensing laws that include the phrase *business opportunity* in the list of things for which a person must be a licensed broker to sell.

## **2. (§67.7) Common Types of Business Opportunities**

The most common types of business opportunity ventures are distributorships, “rack jobbing,” and vending machine routes. In these ventures, the business opportunity seller puts the purchaser into a business of distributing certain goods or services (such as film, juice, or pantyhose), usually those of a well-known third party, by providing or suggesting a supplier for the goods and by representing that the seller will establish retail accounts or place vending machines or rack displays in suitable locations. The purchaser is required to pay a fee or to purchase goods or equipment (such as the vending machines or display racks) in order to participate in the business opportunity offered by the seller.

### **3. (§67.8) Federal Law Definition**

The FTC rule's definition of *business opportunity* is summarized as a commercial relationship created by the following arrangement:

- (1) The business opportunity purchaser (the “purchaser”) offers, sells or distributes goods or services supplied by the business opportunity seller (the “seller”) or other suppliers, either designated by or affiliated with the seller;
- (2) The seller secures retail outlets or accounts for the goods or secures locations for vending devices or racks; and
- (3) The franchisee is required to pay the seller, or its affiliate, at least \$500 within the first six months of operation. 16 CFR §437.2.

### **4. (§67.9) Federal Law Exemptions**

The FTC rule contains numerous exemptions and exclusions to the business opportunity law. *See* 16 CFR 437.2(3) and (4). For example, there is an exemption for a business opportunity that complies with the *franchise* disclosure requirements found at 16 CFR part 436 or that meets an exemption under the franchise law found at 16 CFR part 436.8. 16 CFR part 437.2(3)(v).

### **5. (§67.10) State Law Definitions**

Almost half the states, but not Oregon, currently have statutes governing sales of “business opportunities.”

The definition of *business opportunity* generally follows this pattern:

- (1) A seller “furnishes” (*furnishes* is much broader than *sells*) goods or services;
- (2) For a payment of \$500 or more (in most states, payments for inventory as well as payments for fees or for the purchase of marketing rights are included in calculating the \$500 limit; several states do not calculate bona fide wholesale inventory price payments as part of the \$500 requirement);
- (3) To enable the buyer to “start” (or, in some states, particularly California, to “operate”) a business; and
- (4) The seller represents one or more of the following:

(a) the buyer will earn income that exceeds the cost paid (this can be a common representation, and often implied, in business deals and a real trap for the unwary);

(b) the seller will buy back all or part of the goods or services that the buyer produced;

(c) the seller will find or help find locations for vending machines, video games, merchandise racks, or the like;

(d) if the buyer is unhappy with his or her bargain, the seller will refund some or all of the initial payment or buy back the program; or

(e) the seller will provide a marketing or operating plan to enable the buyer to successfully enter into business operations. (This representation closely parallels the basis on which standard franchise programs operate.)

Caveat: Although many of the above elements are found in various states' laws, differences in statutory language under a particular state law can be significant. The lawyer should closely review the laws of each relevant state when determining how that state's business opportunity laws might be applied to a particular proposed business development program. For example, in Connecticut, state administrators have determined that a representation that a program would produce profits can be implied from the circumstances when no express representation is made.

## **6. (§67.11) State Law Exemptions**

Many states exempt or exclude certain types of investment programs from their business opportunity laws. Although these exemptions or exclusions vary from one state to another, the most common exemptions or exclusions include:

(1) The sale of an ongoing business by its owner;

(2) A low (often less than \$50) bona fide deposit or price paid for the cost of a sales demonstration kit (the result of lobbying efforts by direct sellers (pyramid) associations);

(3) Licensed real estate brokers;

(4) Newspapers;

(5) Buyers who are already actively involved in an ongoing business operation;

- (6) Securities issues that comply with applicable securities laws;
- (7) Licensors of federally registered trademarks; and
- (8) Business format franchisors who comply with the FTC disclosure rules or relevant state franchise registration or disclosure laws.

Practice Tip: Before relying on an exemption or exclusion from coverage under a state business opportunities law, carefully examine the law to determine how best to qualify.

## 7. (§67.12) Private Rights of Action

Most state business opportunity laws provide private rights of action for purchasers or would-be purchasers to bring legal action against sellers for violations of the relevant state requirements. The federal law does not have a corresponding private right of action.

### B. (§67.13) Securities Laws

The lawyer should carefully consider whether or not a particular franchise meets the legal definition of a *security*. This can occur when a franchise arrangement is determined to be an investment contract under relevant securities laws. Federal and state securities laws impose registration and antifraud requirements. A franchisor's violation of these laws may result in criminal and civil liability.

The early definition of *investment contract* was provided by *S.E.C. v. W.J. Howey Co.*, 328 US 293, 299, 66 S Ct 1100, 90 L Ed 1244 (1946). That case defined *investment contract* as an investment of money in a common enterprise with profits to come solely from the efforts of others. This definition does not seem to fit the traditional franchise relationship in which the franchisee exercises significant control over the day-to-day operations of the business. *See, e.g., Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F Supp 640 (D Colo 1970), *aff'd*, 460 F2d 666 (10th Cir 1972). *See also* 1 Advising Oregon Businesses ch 15 (Oregon CLE 2001).

However, the definition of *investment contract* has expanded to include “risk-capital” ventures. This expanded definition has encompassed certain franchise sales. *State v. Consumer Business System*, 5 Or App 19, 482 P2d 549 (1971) (if substantial portion of initial capital that franchisor uses to initiate its operations is

provided by franchisees, franchisor must register enterprise under Oregon's securities laws); see *Jet Set Travel Club v. Corporation Comm.*, 21 Or App 362, 535 P2d 109 (1975).

The California attorney general has opined that a security would exist in a situation in which the franchisor agrees to supply goods and services to the franchisee and intends to secure a substantial portion of the initial capital needed to supply the goods and services from fees paid by franchisees. *Blue Sky L Rep* (CCH) ¶70,747 (June 2, 1967). Thinly capitalized franchisors may be subject to the securities laws in states, such as Oregon, that have accepted the risk-capital approach.

### **C. (§67.14) Unlawful Trade Practices Act**

Many states have “Little FTC Acts” that may impact upon franchises in varying degrees. The Oregon Unlawful Trade Practices Act (“UTPA”) includes “franchises, distributorships and other similar business opportunities” in its definition of *real estate, goods or services*. ORS 646.605(6). Despite the statutory language, however, questions remain about whether the UTPA applies to commercial franchise transactions. See *Graham v. Kold Kist Beverage Ice, Inc.*, 43 Or App 1037, 607 P2d 759 (1979). But see *Goodyear Tire & Rubber Co. v. Tualatin Tire & Auto*, 129 Or App 206, 217, 879 P2d 193 (1994), *aff'd in part, rev'd in part on other grounds*, 325 Or 46 (1997), in which the Oregon Court of Appeals held that a corporation may pursue a private action under ORS 646.638(1) for a claim arising from a commercial franchise transaction. However, the court remanded the case to the trial court to determine whether the transactions regarding the subject franchise fell within the definition of *real estate, goods or services* in ORS 646.605. *Goodyear Tire & Rubber Co.*, *supra*, 129 Or App at 217 n 7.

See Consumer Law in Oregon ch 4 (Oregon CLE 1996 & Supp 2000) for a complete discussion of the UTPA.

### **D. (§67.15) Antitrust Laws (Nonprice Issues)**

In *White Motor Co. v. United States*, 372 US 253, 83 S Ct 696, 9 L Ed2d 738 (1963), the Supreme Court held that nonprice vertical restraints imposed by a manufacturer on its dealers were to be evaluated under the rule of reason. However, in *United States v. Arnold, Schwinn & Co.*, 388 US 365, 87 S Ct 1856, 18 L Ed2d

1249 (1967), the Court held that postsale territorial and customer restraints imposed by a manufacturer on its dealers were per se unlawful. In *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 US 36, 97 S Ct 2549, 53 L Ed2d 568 (1977), the Court expressly overruled *Arnold, Schwinn & Co.* to the extent that it required per se treatment for postsale, nonprice vertical restraints, returning once again to the rule-of-reason analysis.

Comment: Chapter 58, *supra*, provides an overview of antitrust laws. The discussion in §§67.16–67.21, *infra*, only summarizes the impact that the antitrust laws may have on the franchisor-franchisee relationship.

### **1. (§67.16) Exclusive Distribution**

A franchisor can grant exclusive distribution rights to a franchisee in a designated territory. See *Carlson Mach. Tools, Inc. v. American Tool, Inc.*, 678 F2d 1253, 1259 (5th Cir 1982). A franchisor may also be able to justify restraints on a franchisee's right to sell in another franchisee's territory. See *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 US 36, 97 S Ct 2549, 53 L Ed2d 568 (1977). Thus, for example, a franchisor's requirement that an Oregon franchisee not sell to customers in Washington is analyzed under the rule of reason. See *Beltone Electronics Corp.*, 100 FTC 68, 43 Antitrust & Trade Reg Rep (BNA) 112 (July 6, 1982).

### **2. (§67.17) Territorial Restrictions**

Horizontal allocations of territory (division of a market by competitors) have always been per se illegal. However, as a result of *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 US 36, 97 S Ct 2549, 53 L Ed2d 568 (1977), vertical allocation of territory will be analyzed under the rule of reason. *Maykuth v. Adolph Coors Co.*, 690 F2d 689 (9th Cir 1982), *vacated and remanded on other grounds*, 820 F2d 303 (1987); *Carlson Mach. Tools, Inc. v. American Tool, Inc.*, 678 F2d 1253 (5th Cir 1982). It is likely that most franchisors can justify territorial allocations as promoting interbrand competition.

### **3. (§67.18) Tying Arrangements**

A seller with “market power” in a particular product may not condition the sale of that product on the buyer's agreement to also purchase a separate product

from the seller. In *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 US 2, 104 S Ct 1551, 80 L Ed2d 2 (1984), the Court identified three sources of market power: (1) a government-granted patent or similar monopoly over a product, (2) a high market share, or (3) a unique product that competitors are unable to offer. The five-Justice majority continued to recognize per se condemnation when “forcing” is probable, that is, when a seller uses its market power to force the buyer into purchasing a tied product that the buyer either did not want at all or might have preferred to purchase elsewhere on different terms. Because many franchisors require franchisees to purchase inventory, supplies, equipment, and other items from the franchisor (or a source designated by the franchisor), tie-in issues abound in the franchising area.

In *Golden West Insulation v. Stardust Investment Co.*, 47 Or App 493, 504, 615 P2d 1048 (1980), the Oregon Court of Appeals held that an exclusive trademark or service mark alone cannot create a presumption of sufficient economic power over the market for the tying product. The franchisee must prove that the franchisor possesses sufficient economic power.

In *Digidyne Corp. v. Data General Corp.*, 734 F2d 1336 (9th Cir 1984), the Ninth Circuit held that copyright protection results in a presumption of market power because it creates barriers to the entry of competitors in the tying product market. Compare *Mozart Co. v. Mercedes-Benz of North America, Inc.*, 833 F2d 1342 (9th Cir 1987), in which the court stated that a prestigious trademark is not itself persuasive evidence of economic power.

In *Will v. Comprehensive Accounting Corp.*, 776 F2d 665 (7th Cir 1985), the Seventh Circuit examined an alleged tie-in between the sale of accounting service franchises and the sale of data processing services. The court found that the franchisees failed to show market power directly because there was no evidence that the price they paid for the franchise and data processing as a package was higher than the price of the products purchased as components in separate markets. The franchisor “licensed its trademark cheaply in order to sell expensive computation.” *Will, supra*, 766 F2d at 673.

For an illegal tying arrangement to exist, two separate products must be offered for sale. In the franchising area, a critical question is whether the trademark is the tying product. In *Siegel v. Chicken Delight, Inc.*, 448 F2d 43, 47–49 (9th Cir 1971), the Ninth Circuit concluded that Chicken Delight’s trademark was a distinct

product and that its sale or license could not be conditioned on the purchase of other commonplace items from the trademark owner. However, in *Krehl v. Baskin-Robbins Ice Cream Co.*, 664 F2d 1348, 1353 (9th Cir 1982), the court rejected a claim that Baskin-Robbins illegally required its franchisees to purchase Baskin-Robbins ice cream. The court held that the franchise outlets “serve merely as conduits through which the trademarked goods of the franchisor flow to the ultimate consumer.” *Krehl, supra*. See *Hamro v. Shell Oil Co.*, 674 F2d 784 (9th Cir 1982).

In *Principe v. McDonald’s Corp.*, 631 F2d 303 (4th Cir 1980), the Fourth Circuit rejected a challenge to McDonald’s practice of requiring franchisees to lease their stores from McDonald’s. The court held that McDonald’s sells only one product, the franchise agreement and store lease being components of a single overall package.

While tying arrangements are per se illegal, the Ninth Circuit has recognized in many decisions that defendants may demonstrate a business justification for an otherwise per se illegal tying arrangement. *Mozart Co. v. Mercedes-Benz of North America, Inc.* 833 F2d 1342 (9th Cir 1987) (The Ninth Circuit recognized business justifications such as quality control and protection of goodwill).

In *Butler Enterprises #97, Inc. v. Vanlandingham* 505 P2d 1149 (1973), the Oregon Supreme Court held that no illegal tying arrangement existed merely because a franchise agreement required the franchisee to purchase supplies from the franchisor or suppliers designated by the franchisor. The record did not show whether the franchisor was legitimately controlling product quality, whether the franchisee was required to pay higher prices for supplies than competing suppliers would have charged or whether the franchisor was attempting to hide markups or rebates from suppliers.

## **E. Antitrust Laws (Pricing-Related Issues)**

### **1. (§67.19) Resale Price Maintenance**

Resale price maintenance is a vertical restriction that is per se illegal even after *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 US 39, 51 n 18, 97 S Ct 2549, 53 L Ed2d 568 (1977). See §67.15. Although a franchisor may suggest retail prices for franchisees, it cannot take any action to coerce compliance.

## 2. (§67.20) Boycotts and Refusals to Deal

Boycotts and concerted refusals to deal may be illegal. *See* chapter 58, *supra*.

An issue could arise, for example, if a group of franchisees prevailed on the franchisor to refuse to deal with another franchisee. *See Com-Tel, Inc. v. DuKane Corp.*, 669 F2d 404 (6th Cir 1982).

A franchisor that terminates a franchisee in response to complaints from other franchisees about the franchisee's pricing practices may violate antitrust laws. However, it is usually difficult to prove a conspiracy to terminate or to counter allegations that other reasons for termination existed. *See Spray-Rite Service Corp. v. Monsanto Co.*, 684 F2d 1226 (7th Cir 1982), *aff'd*, 465 US 752 (1984); *Filco v. Amana Refrigeration, Inc.*, 709 F2d 1257 (9th Cir 1983). Furthermore, an agreement to terminate a price-cutting franchisee is not per se illegal without an express or implied agreement on price between the franchisor and the complaining franchisee. *Business Electronics v. Sharp Electronics*, 485 US 717, 108 S Ct 1515, 99 L Ed2d 808 (1988).

## 3. (§67.21) Price Discrimination

The Robinson-Patman Act, 15 USC §13(a), prohibits discrimination in pricing products sold to purchasers in the same level of competition. Price discrimination claims are rare in the franchising area because most franchisors have uniform price schedules for products sold to franchisees. Price discrimination claims could arise if a franchisor or an affiliate operates outlets competing with a franchisee. Transfers to a company-owned outlet or an affiliate-owned outlet are not "purchases" for purposes of the Robinson-Patman Act. *See Shavrnock v. Clark Oil & Refining Corp.*, 726 F2d 291 (6th Cir 1984) (intra-corporate transfers between oil company and its company-operated stores did not constitute sale within meaning of Robinson-Patman Act); *O'Byrne v. Cheker Oil Co.* 727 F2d 159 (7th Cir 1984); and *Eximco, Inc. v. Trane Co.* 737 F2d 505 (5th Cir 1984).

The Oregon Anti-Price Discrimination Act is set forth in ORS 646.010–646.180.

# IV. FRANCHISE DISCLOSURE LAWS

## A. Federal Law

### 1. (§67.22) Franchise Disclosure Document

The FTC rule requires franchisors to prepare a written Franchise Disclosure Document (“FDD”) and to deliver it to prospective franchisees in compliance with specified methods and time frames. 16 CFR pt 436. The information to be included in the FDD is found at 16 CFR part 436.5. The FTC Statement of Basis and Purpose provides additional clarifications. *See* Bus Franchise Guide (CCH) ¶¶6052 to 6082 (July 1, 2007).

Disclosure information is divided into the following 23 categories or “Items”:

1. The Franchisor and any Parents, Predecessors and Affiliates
2. Business Experience
3. Litigation
4. Bankruptcy
5. Initial Fees
6. Other Fees
7. Estimated Initial Investment
8. Restrictions on Sources of Products and Services
9. Franchisee’s Obligations
10. Financing
11. Franchisor’s Assistance, Advertising, Computer Systems, and Training
12. Territory
13. Trademarks
14. Patents, Copyrights and Proprietary Information
15. Obligation to Participate in the Actual Operation of the Franchisee Business
16. Restrictions on What the Franchisee May Sell
17. Renewal, Termination, Transfer and Dispute Resolution
18. Public Figures
19. Financial Performance Representations
20. Outlets and Franchisee Information
21. Financial Statements
22. Contracts
23. Receipts

16 CFR §436.5.

The Franchisor must respond fully to each disclosure item in the FDD. 16 CFR §436.6(c). The Franchisor must “[d]isclose all required information clearly, legibly, and concisely in a single document using plain English.” 16 CFR §436.6(b). The Franchisor may include state-specific disclosure information in the body of the FDD or as an Exhibit (often referred to as a “State Law Addendum”). CFR §436.6 (e). *See also* §67.28. Additional instructions are found at CFR §436.6.

Note: Of particular importance is that all financial performance representations a franchisor might make to a prospective franchisee must comply with requirements of the FTC rule. 16 CFR §436.5(s).

### **3. (§67.23) Disclosure Updates**

Under the FTC rule, the franchisor must update disclosures in its FDD annually within 120 days of the franchisor’s last fiscal year end. 16 CFR §436.7(a). In addition, the franchisor must update the FDD within a reasonable time after the close of each fiscal quarter if there have been any material changes to information disclosed in the FDD. 16 CFR §436.7(b). *See* 16 CFR §436.7 for more detailed information.

Caveat: Some states require registration of franchise offerings and require the franchisor to amend its franchise registration to reflect changes to information disclosed in the FDD. Several of these states require amendments to be submitted within a reasonable time (often 30 days) after disclosure information materially changes rather than after the close of each fiscal quarter. *See* §67.29.

### **4. (§67.24) Notice of Available Disclosure**

Under the FTC rule, the franchisor must inform the prospective franchisee of the format(s) in which the FDD is available (e.g. paper/Internet/CD-ROM/e-mail) before delivering the FDD. 16 CFR §436.6(g). The franchisor must also advise the prospective franchisee of any prerequisites for obtaining or reviewing the disclosure in a particular format (such as required computer memory and software). *Id.*

Practice Tip: If there is ever a question as to whether or not this notice was

provided, it will be the franchisor's responsibility to prove that it was in fact provided. The lawyer should encourage the franchisor to deliver this notice in writing and to keep a copy to prove compliance. The FDD has a specific, duplicate form of Acknowledgment of Receipt.

## **5. (§67.25) Disclosure Methods**

The FTC rule permits the franchisor to deliver the disclosure document to a prospective franchisee in hardcopy or electronic format. Electronic delivery includes delivery by email, computer disk or CD ROM or by posting the document on the Internet. 16 CFR §436.2(c). In an electronic disclosure document, the franchisor may include search features such as scroll bars and internal links to help the prospective franchisee navigate the document. However, all other features are prohibited, including links to external information, pop-up screens, animation, video and audio. 16 CFR §436.6(d).

## **6. (§67.26) Timing for Making Disclosures**

Under the FTC rule, if the business relationship qualifies as a *franchise*, then the franchisor must give the prospective franchisee an FDD "at least 14 calendar-days before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or an affiliate in connection with the proposed franchise sale." 16 CFR §436.2(a).

**Caveat:** Several states require disclosure waiting periods that are different than the 14 calendar-day waiting period required by the FTC rule. For example, some states have a 10 business-day waiting period and exclude state and federal holidays.

If the franchisor unilaterally and materially alters the terms and conditions of its standard franchise agreement or any other agreements attached to the FDD, then the franchisor must give the prospective franchisee a copy of each revised agreement at least 7 calendar-days before the prospect signs the revised agreement. However, if the prospect initiates the changes to the agreement(s), then this 7 calendar-day cooling off requirement does not apply. 16 CFR §436.2(b).

Caveat: In some situations involving negotiation of the terms of the franchise agreement or related agreements, state franchise laws may require the franchisor to re-disclose the prospective franchisee with an updated FDD and file the updated FDD as an amendment to the current state franchise registration. *See* §67.29.

## **B. (§67.27) Oregon Law**

ORS chapter 650 does not require the registration of franchise offers or sales. However, administrative rules promulgated under ORS chapter 650 require the prior disclosure of information to prospective franchisees and compliance with the FTC rule. *See* OAR 441-325-010 to 441-325-050. Civil remedies for violations are discussed in §§67.34–67.35.

## **C. (§67.28) Other State Laws**

Several states have statutes and regulations requiring disclosures in connection with a proposed franchise sale. Some states have additional or supplemental requirements to the FDD.

**Practice Tip:** The lawyer should consider preparing a State Law Addendum as an exhibit to the FDD for a franchisor that will be offering franchises nationwide or in multiple states. The FTC rule (16 CFR §436.6(e)) and most states allow state-specific information (that varies from or adds to disclosures in the body of the FDD) to be reflected in a State Law Addendum. By using the State Law Addendum, the lawyer avoids the need to create an entirely separate document for each relevant state. *E.g.* A franchisor's FDD may reflect the franchisor's decision to have disputes governed by the laws of its home state and to have disputes resolved in its home state. However, some state franchise laws require the governing law and forum for dispute resolution to be the state in which the franchisee is located, along with other state mandated restrictions or requirements.

Caveat: State regulation of franchises varies significantly, so the lawyer must review the laws of a particular state before advising a franchisor on the proper timing, contents and method for making pre-sale disclosures in that state. A list of the state franchising statutes is set forth in Appendix 67A. The list in Appendix 67A should not be used as a substitute for research to discover whether a state has

adopted, modified, or repealed any franchise laws.

## **V. (§67.29) FRANCHISE REGISTRATION LAWS**

Neither the FTC rule nor Oregon law require the franchisor to register the franchise offering before the franchisor may offer or sale a franchise. However, several states do have franchise registration or exemption laws. Typically, the application for registration must be accompanied by the proposed FDD and other application materials. In several states, state administrators review the FDD for its content. In some states, conditions to registration may be imposed, such as deferral, escrow or impoundment of franchise fees, or the filing of a surety bond to assure the fulfillment of the franchisor's obligations.

Most states that have franchise registration or exemption laws require franchise registration to be renewed annually or more frequently if there are material changes to information disclosed in the franchisor's FDD. In some situations involving negotiation of the terms of the franchise agreement or related agreements, state franchise laws may require the franchisor to file an amendment to its existing state franchise registrations or otherwise comply with negotiation standards and requirements. *See* Appendix 67A. The state of California requires the franchisor to file with the state a "Notice of Negotiated Change." Cal Corp Code §31109.1 (West 1997 & Supp 2002).

Caveat: State regulation of franchises varies significantly, so the lawyer must review the laws of a particular state before offers or sales are made involving that state. A list of the state franchising statutes is set forth in Appendix 67A. The list in Appendix 67A should not be used as a substitute for research to discover whether a state has adopted, modified, or repealed any franchise laws.

## **VI. FRANCHISE RELATIONSHIP LAWS**

### **A. (§67.30) Statutes**

Several states have statutes that may supersede the Franchise Agreement in a franchisee's relationship with the franchisor, including the areas of termination and renewal of the franchise, venue for disputes and governing law.

These statutes are identified in Appendix 67A. (*See, e.g.*, California Franchise Relations Act, Cal Bus & Prof Code §20025 (West 1997 & Supp 2002). Section 20025 requires a franchisor to give 180 days' prior written notice of its intention not to renew the franchise. That section also requires a franchisor to permit the franchisee to sell the business within the 180-day notice period to a purchaser meeting the franchisor's current requirements for granting franchises. It prohibits a franchisor from refusing to renew for the purpose of converting the franchisee's business operation for the franchisor's account.)

Two federal statutes and many state statutes govern the franchise relationship in specific industries. The Automobile Dealer Franchise Act (informally known as the "federal dealer day-in-court law") 15 USC §§1221–1225, subjects automobile manufacturers to civil liability for failing to act in good faith in performing or complying with the terms of the franchise or in terminating, canceling, or not renewing a dealer's franchise. *See also* ORS 650.140. The Petroleum Marketing Practices Act, 15 USC §§2801–2806, contains detailed provisions pertaining to the relationships between oil refiners, distributors, and retailers. *See also* ORS 650.200–650.250 (motor fuel franchises).

Note: Several jurisdictions have distribution or dealership laws that may impact upon franchise systems, such as Wisconsin and Puerto Rico.

## **B. (§67.31) Common Law**

Court decisions in the states listed in Appendix 67A and other states may supersede the franchise agreement in a franchisee's relationship with the franchisor.

In *William C. Cornitius, Inc. v. Wheeler*, 276 Or 747, 556 P2d 666 (1976), the Oregon Supreme Court refused to recognize an implied obligation inherent in an oil company–dealer relationship to renew a lease and dealer service contract. Compare *Bronken's Good Time Co. v. J.W. Brown & Associates*, 661 P2d 861, 864 (Mont 1983), in which the court held that when a distributorship agreement contains no provision for its termination and the distributor has made a substantial investment in establishing or furthering the distributorship, the agreement may be terminated only after a reasonable time has elapsed and reasonable notice of termination is given.

Comment: A franchisee may invest a substantial amount of time, effort, and money in developing a franchise. The franchisor's termination of the franchise agreement or refusal to renew the franchise can be devastating to the franchisee. In contrast, the franchisor may derive a valuable benefit from taking over the franchised location with its associated goodwill. Some courts acknowledgment these issues and decide accordingly.

## VII. ENFORCEMENT

### A. (§67.32) FTC

#### 1. Generally

The FTC has broad powers under §5 of the Federal Trade Commission Act, 15 USC §45(b), to investigate business practices in the franchising area. With the promulgation of the FTC rule, the FTC has determined that a franchisor's failure to provide the required disclosures at the required time is a violation of §5 of the Federal Trade Commission Act. The FTC may issue cease-and-desist orders (15 USC §45(b)); bring suit in federal court for preliminary and temporary injunctions and restraining orders (15 U.S.C. §53); seek and obtain permanent injunctions; and seek civil penalties of up to \$10,000 for each act or practice found to be unfair or deceptive if the defendant had actual knowledge that the act or practice was unfair or deceptive. 15 USC §45(m)(1)(B). *See Federal Trade Commission v. Value Investments, Ltd.* (MD La 1994). (A mortgage loan brokerage franchisor and its officers that violated the FTC Act by making misrepresentations and failing to provide disclosure documents in the sale of their franchises were permanently enjoined from engaging in any future violations and were jointly and severally liable for \$7,832,492, plus interest, costs, and attorneys' fees.). The FTC may seek criminal penalties as well. *See U.S. v. Jaspon* (MD Fla 1991).

#### 2. (§67.33) No Private Right of Action

A note to the FTC's Statement of Basis and Purpose confirms the fact that there is no private right of action for violations of the FTC rule. Bus Franchise Guide (CCH) ¶6062 (July 1, 2007), note 350. *See also Days Inn of America Franchising, Inc. v. Windham*, 699 F Supp 1581 (ND Ga 1988).

## **B. Private Civil Remedies**

### **1. (§67.34) Oregon Law**

A person who sells a franchise is liable to the franchisee if he or she (1) employs any device, scheme, or artifice to defraud, (2) makes any untrue statement of a material fact, or (3) omits to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. ORS 650.020(1).

Oregon law also provides for the liability of the seller's partners, officers, and directors, and persons participating or materially aiding in the sale unless the nonseller did not know, and in the exercise of reasonable care could not have known, of the existence of the facts on which liability is based. ORS 650.020(5). ORS 650.020 is modeled after the liability section of the Oregon Securities Law, ORS 59.115, which is liberally construed in favor of the public. *See Foelker v. Kwake*, 279 Or 379, 385, 568 P2d 1369 (1977).

In *Goodyear Tire & Rubber Co. v. Tualatin Tire & Auto*, 129 Or App 206, 213–214, 879 P2d 193 (1994), *aff'd in part, rev'd in part on other grounds*, 325 Or 46 (1997), the Oregon Court of Appeals held that when a promise is claimed to be an “untrue statement of a material fact” under ORS 650.020(1)(b), there must be proof of an intent not to perform.

In *Goodyear Tire & Rubber Co. v. Tualatin Tire & Auto*, 322 Or 406, 908 P2d 300 (1995), *opinion adhered to*, 325 Or 46 (1997), the Oregon Supreme Court held that a franchisee seeking a remedy under ORS 650.020(3) has a right to a jury trial.

In an action under ORS 650.020 against the seller of a franchise, the franchisee may recover any amounts to which the franchisee would be entitled in an action for rescission. The court may award reasonable attorney fees to the prevailing party, except when the prevailing party is a defendant in a class action. ORS 650.020(3)–(4).

### **2. (§67.35) Other State Laws**

State franchise laws often provide civil remedies for franchisees when the franchisor violates franchise disclosure, registration or relationship laws. Under

state franchise laws, the two major remedies are (1) rescission and (2) recovery of damages. The state franchise laws typically provide for recovery of attorneys' fees and costs as well. *See* Appendix 67A; *Dollar Systems, Inc. v. Avcar Leasing Systems*, 890 F2d 165 (9th Cir 1989) (franchisor failed to file notice that it was exempt from registration requirements of California Franchise Investment Law and provided disclosure statement to franchisee that failed to disclose material facts; because sale of franchise was unlawful, franchisee had right to rescind immediately on execution); *Video Update, Inc. v. Guenther*, 741 F Supp 172 (D Minn 1990) (although franchisor provided franchisee with UFOC disclosure statement, it was not version in effect on date of sale); *Morris v. International Yogurt Co.*, 107 Wash2d 314, 729 P2d 33 (1986) (nondisclosure that "unique" product was available to non-franchisees was material omission from offering circular).

In some states, franchisees might recover up to three times their actual damages. For example, the Washington Franchise Investment Protection Act provides for treble damages in the discretion of the court. RCWA 19.100.190(3) (2002).

In many states, the principal officers and directors of the violating franchisor may be subject to joint and several liability. *See* Appendix 67A.

Note: It is possible for a franchise sale to violate the laws of more than one state. For example, a Washington franchisor selling a franchise to be located in Oregon may be required to comply with the laws of both states. It is also possible for an "offer" to sell to be made in one state and a "sale" to be made in another state.

### **C. (§67.36) State Regulators**

Generally speaking, state franchise laws provide regulators with broad powers to investigate violations and to enforce the laws. *See* ORS 650.055. States may sue franchisors in the name of the state and receive injunctions, awards for attorney fees, and other remedies. *See* ORS 650.065 and Appendix 67A. Also, the states have broad investigative powers, including the powers to issue subpoenas and to compel testimony.

### **D. (§67.37) Criminal Penalties**

State franchise laws often include penalties or criminal sanctions for willful

violations. *See, e.g.*, Cal Corp Code §31410 (West 1997 & Supp 2002) (up to \$100,000 and one-year imprisonment).

#### **E. (§67.38) Class Actions**

One or more franchisees can attempt to represent a class of franchisees and bring a class action against a franchisor when common questions of law and fact exist. FRCP 23. However, when questions of fact affecting only individual members predominate over questions of fact common to all members of the proposed class, certification of the class will be denied. *Ungar v. Dunkin' Donuts of America, Inc.*, 531 F2d 1211 (3d Cir 1976).

### **VIII. (§67.39) INTERNATIONAL FRANCHISING**

While franchising is not regulated in most foreign countries, more and more countries are enacting franchise laws. Some of these laws impose franchise disclosure and registration requirements and regulate the franchise relationship. For example, the Canadian provinces of Alberta, New Brunswick, Ontario, and Prince Edward Island have detailed franchise relationship standards and disclosure requirements (but no registration requirements). The Uniform Law Conference of Canada adopted the Uniform Franchises Act, Regulation of Disclosure Documents, and Regulation on Mediation. Among other things, it specifies what information is required in a disclosure document.

Currently, the CCH Business Franchise Guide contains detailed analysis and statutory renditions for Australia, Belgium, Brazil, Canada, China, the European Union, France, Indonesia, Italy, Japan, Kazakhstan, Korea, Lithuania, Malaysia, Mexico, Romania, Russia, Spain, Sweden, Taiwan, Venezuela and Vietnam.

## **Appendix 67A                      States with Franchise and Business Opportunity Statutes and Regulations**

### **States with Franchise Disclosure and Registration Laws**

*Alabama*

*Arkansas*  
*California*  
*Florida*  
*Hawaii*  
*Illinois*  
*Indiana*  
*Maryland*  
*Michigan*  
*Minnesota*  
*Mississippi*  
*New York*  
*North Dakota*  
*Oregon*  
*Rhode Island*  
*South Dakota*  
*Virginia*  
*Washington*  
*Wisconsin*  
*District of Columbia*

**States with Business Opportunity Disclosure and Registration Laws**

*Alabama*  
*Alaska*  
*California*  
*Connecticut*  
*Florida*  
*Georgia*  
*Illinois*  
*Indiana*  
*Iowa*  
*Kentucky*  
*Louisiana*  
*Maine*  
*Maryland*

*Michigan*  
*Minnesota*  
*Nebraska*  
*New Hampshire*  
*North Carolina*  
*Ohio*  
*Oklahoma*  
*South Carolina*  
*South Dakota*  
*Texas*  
*Utah*  
*Virginia*  
*Washington*  
*District of Columbia*

**States with Franchise Relationship Laws**

*Alaska*  
*Arkansas*  
*California*  
*Connecticut*  
*Delaware*  
*Florida*  
*Hawaii*  
*Idaho*  
*Illinois*  
*Indiana*  
*Iowa*  
*Kentucky*  
*Louisiana*  
*Maryland*  
*Massachusetts*  
*Michigan*  
*Minnesota*

*Mississippi*  
*Missouri*  
*Nebraska*  
*New Jersey*  
*North Carolina*  
*North Dakota*  
*Rhode Island*  
*Virginia*  
*Washington*  
*Wisconsin*  
*District of Columbia*

**States with Franchise and Business Opportunity Regulations**

*California*  
*Hawaii*  
*Illinois*  
*Iowa*  
*Kentucky*  
*Maryland*  
*Minnesota*  
*New York*  
*Oklahoma*  
*Oregon*  
*Rhode Island*  
*Texas*  
*Utah*  
*Virginia*  
*Washington*  
*Wisconsin*

**States with No General Franchise or Business Opportunity Disclosure,  
Registration or Relationship Statutes**

*Arizona*  
*Colorado*  
*Kansas*  
*Massachusetts*  
*Montana*  
*Nevada*  
*New Mexico*  
*Pennsylvania*  
*Vermont*  
*West Virginia*  
*Wyoming*

Caveat: This list should not be used as a substitute for research to discover whether a state has adopted, modified, or repealed any franchise laws.

Comment: This Appendix 67A does not include special industry franchise laws that exist in some states for petroleum products, motor vehicles, alcohol and other industries.