

(Author's note: In 1989 I was contacted by a husband and wife wanting to franchise their pizza store. I wrote their first documents and represented them for the next 12 years, eventually shepherding East of Chicago Pizza Company to become a 100+ unit chain operating in 5 states. This article was published in 1993 in Ohio Lawyer Magazine, a publication sponsored by the Ohio Bar Association.

While the article is still useful to describe the general legal environment of franchising, it should be noted that the FTC Rule was amended in 2007, and the Ohio Law was amended in 2012.)

# Franchising In Ohio

## Practical Aspects Of The Law

by Stanley M. Dub

**Author's Note:** *This article will acquaint the practitioner with the legal requirements applicable to a sale of franchises in Ohio. Once these requirements have been met, the laws of each state must be examined on a case-by-case basis as the franchisor proposes to extend its reach outside Ohio.*

### Introduction

Franchising has been called "the single most successful marketing concept ever."<sup>1</sup> Nationwide, there are more than 540,000 franchise businesses, generating annual sales of more than \$758 billion.<sup>2</sup> Franchising is no less significant in Ohio.

Offering franchises is subject to a trade rule of the Federal Trade Commission (FTC) and numerous state laws, many of which conflict with the FTC rule in various respects.<sup>3</sup> Furthermore, the franchise relationship invariably raises federal antitrust and trademark law issues; a significant feature of the typical franchise agreement is the requirement the franchisee purchase certain items only from the franchisor or other approved sources.<sup>4</sup> Because the FTC rule does not preempt all conflicting state laws, a business proposing to offer franchises in numerous states faces a daunting legal task. Not only must the franchisor prepare disclosure documents which comply with both the FTC rule and any conflicting state laws, but the franchisor must also insure its agreements do not violate local franchise or antitrust laws.

In some states, such as West Virginia, no special disclosure requirements are imposed on franchisors beyond those already imposed by FTC rule.<sup>5</sup> Thus, a franchisor already complying with Ohio law and FTC rule could legally offer franchises in West Virginia without altering its disclosure documents or procedures.

By contrast, the franchisor could generally not offer franchises in a state such as Indiana without making significant alterations to its procedures and documentation. Legislation in Indiana includes a franchise law (requiring registration in certain cases), a business opportunity transactions law, and a deceptive franchise practices law, which would prohibit many franchise agreement terms which are commonplace in other states.<sup>6</sup>

### The Ohio Law

Ohio's Business Opportunity Purchaser's Protection Act (ORC§1334.01 et seq.) regulates the offer, sale or lease of a franchise or other business opportunity plan unless an exemption applies to either the transaction or the parties.

The Ohio law is very broad; it covers most traditional franchise relationships as well as a variety of other transactions which involve the sale of a business opportunity plan.

A "business opportunity plan" is an agreement between the seller and a purchaser where:

- The purchaser obtains the right to offer,

sell or distribute goods or services which are either supplied by the seller, a person affiliated with the seller, or a third person with whom the purchaser is required or advised to do business;

- The purchaser is required to make an initial payment of between \$500 and \$50,000; and

- The seller makes certain representations.<sup>7</sup>

A literal reading of Ohio law would seem to exclude coverage of 'package franchises' where the franchisor does not require or advise that purchases of goods or services be made from specific vendors. However, there seems no good reason for the legislature to have included product franchises while excluding package franchises, and this result was probably unintentional.<sup>8</sup> A "product franchise" is a distribution arrangement where the franchisee distributes goods manufactured by the franchisor (e.g., an automobile dealership). In a "package franchise," the franchisee operates under the franchisor's trademark, and distributes goods or services which may be purchased from third parties, but must meet the franchisor's quality standards (e.g., a typical fast food franchise).

If a seller is involved in the offer of a business opportunity plan, and the transaction or parties are not otherwise exempt, the seller must provide disclosure documents to the purchaser at least ten days before execution of any relevant agreement. Ohio law also contains provisions

regulating selling practices regarding business opportunity plans, provides purchasers with a five-day right of rescission after signing an agreement, and requires certain information be included in the agreement itself.<sup>9</sup>

Purchasers are given a private right of action to enforce violations, and successful plaintiffs may rescind an offending transaction, recover the greater of triple damages or \$10,000, and receive an award of reasonable attorneys fees. In addition, the Ohio attorney general is authorized to investigate violations.<sup>10</sup>

**The Federal Trade Commission Rule**

The Federal Trade Commission rule requires a franchisor to make extensive disclosures to potential franchisees, at the earliest of:

- The first face-to-face meeting between a prospective franchisee and the franchisor (or any agent or broker of the franchisor) for the purpose of discussing the sale of the franchise;
- Ten days before execution of the franchise agreement; or
- Ten days before payment by the franchisee for the sale.

With minor variations, the FTC rule covers the same types of transactions as Ohio law.<sup>11</sup> Because compliance with Ohio law does not exempt a transaction from coverage under the FTC rule, and because Ohio law contains a broad exemption for transactions which comply with the FTC rule, the practitioner will typically find it advantageous to disregard the specific requirements of Ohio law, and comply instead with the FTC rule.<sup>12</sup>

**Covered Transactions and Exemptions**

The FTC rule is intended to reach product franchises, package franchises (sometimes referred to as business format franchises), and business opportunity franchises.

A "business opportunity franchise" is an arrangement which does not involve affiliation with the franchisor's trademark. Typically the franchisee pays the franchisor for providing assistance in connection with the distribution of goods or services obtained from others. An example would be an arrangement for the distribution of vending machines, where the "franchisor" promised help in finding locations for the machines.

Product franchises and business opportunity franchises would clearly also be reached by Ohio law, and Ohio law would arguably extend to package franchises as well.<sup>13</sup>

Ohio law and the FTC rule also share certain exemptions and exclusions. However, Ohio law has a number of exemptions which are not contained in the FTC rule, and the FTC rule has at least one exemption which is substantially more restrictive than the analogous Ohio exemption.<sup>14</sup> Also the Ohio law exempts transactions where the purchaser pays more than \$50,000, while the FTC rule contains no comparable exemption.

As a result, a franchisor proposing to rely on an exemption must insure that the exemption is available under *both* Ohio law and the FTC rule. If a franchisor fails to make necessary disclosures based upon an exemption available only under Ohio law or the FTC rule, but not both, the franchisor would probably violate aspects of the other body of regulation. The availability of an exemption under Ohio law would clearly not exempt a franchisor from compliance with the FTC rule.

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**Disclosure Documents**

State laws regarding franchises are preempted by the FTC rule unless a state law "would provide protection to the prospective franchisees equal to or greater than that imposed by the rule."<sup>15</sup>

As indicated, Ohio law contains a specific exemption for transactions complying with the FTC rule, and this makes a section by section comparison with the FTC rule unnecessary in Ohio where a franchisor complies with the FTC rule. However, where applicable state laws do

not contain a broad exemption for compliance with the FTC rule, the practitioner would ordinarily be faced with the task of preparing a hybrid disclosure document which complied with both the FTC rule and any applicable state laws and regulations.

To remedy this situation, the Midwest Securities Commissioners Association created a Uniform Franchise Offering Circular (UFOC) which not only satisfies the FTC rule, but also complies with the laws of numerous states. Ohio law, for example, has a specific exemption for transactions using the UFOC disclosure document.<sup>16</sup>

A comparison of the disclosure document required by FTC rule ("the FOC") and the UFOC is beyond the scope of this article, but the UFOC requirements are somewhat more burdensome, and the FTC rule specifies that a franchisor may not pick and choose elements of each, but must instead choose one or the other format in its entirety. Pending proposed revisions to the UFOC would increase the burden further. The proposed changes would require *inter alia* that the UFOC be written in "plain English," the franchisor forecast future charges, and the UFOC employ a specific format (spacing, typeface, etc.).<sup>17</sup>

One significant difference is noteworthy. The UFOC provides financial statements must be fully audited (except for interim periods), and must include audited balance sheets and audited profit and loss statements for the last three fiscal years (except in cases where the franchise may have been formed more recently than three years).<sup>18</sup> By contrast, the FOC would permit use of unaudited financial information for as long as one to two years after the commencement of franchising (if audited statements have not previously been prepared).<sup>19</sup>

**Private Enforcement**

Ohio law makes specific provision for a private right of action, but, as yet, no court has allowed a private right of action for violation of the FTC rule, despite the Federal Trade Commission's hope that courts would do so.<sup>20</sup> However, where an Ohio franchisee is injured by a franchisor's defective compliance with the FTC rule, the franchisor's conduct would seemingly constitute a failure to satisfy Ohio law's exemption for FTC rule compliance, and the injured party would, therefore, typically have a private right of action under Ohio law.<sup>21</sup> But if a franchisor is exempt under Ohio Law, because, for example, the

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franchisor's net worth exceeded five million dollars, an Ohio franchisee would have no cause of action and could only complain to the FTC.

It should be noted legislation was introduced in Congress in 1992, which would create a private right of action for violation of the FTC rule.<sup>22</sup>

### Conclusion

Franchising is a complicated, legal-intensive way of doing business, but it remains an attractive strategy for many businesses when compared with the alternative of financing numerous company-owned outlets.

When a client wishes to franchise solely in Ohio, it will generally be advantageous to comply with the FTC rule, and thereby satisfy an exemption under Ohio law, rather than comply with the specific requirements of Ohio law.

It will then be necessary to

examine laws and regulations applicable to franchises in other states on a case-by-case basis, before the client expands his or her franchise operations outside Ohio.



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### Endnotes

<sup>1</sup>John Naisbitt, author of "Megatrends," quoted in International Franchise Association, *Franchise Opportunities Guide*, 10 (1993).

<sup>2</sup>International Franchise Association, *Franchise Opportunities Guide*, 10 (1993).

<sup>3</sup>16 C. F.R. §436.1 et seq. and see generally, 1 *CCH Business Franchise Guide*, §2000 et seq.

<sup>4</sup>Compare *Siegel v. Chicken Delight*, 448 F2d 43 (9th Cir. 1971), *Kentucky Fried Chicken Corporation v. Diversified Packaging Corporation*, 549 F2d 368 (5th Cir.

1977), and *Krehl v. Baskins-Robbins Ice Cream Company*, 664 F2d 1348 (9th Cir. 1982.)

<sup>5</sup> Like most states, West Virginia has laws which relate to specific types of franchise relationships (automobile dealers, gasoline dealers, alcoholic beverage distributors, etc.) However, this article considers only laws and regulations which apply generally to franchises and business opportunities, regardless of the type of business involved.

<sup>6</sup> See 1 *CCH Business Franchise Guide*, §§3140, 3148, 4140 and 5140.

<sup>7</sup> ORC §1334.01(D)(3).

<sup>8</sup> See comment, *The Business Opportunity Purchasers Protection Act: The Unfulfilled Promise to Ohio Franchisees*, 41 OSJL 477 (1980).

<sup>9</sup> ORC §§1334.02-1334.06.

<sup>10</sup> ORC §1334.09 and ORC §1334.08.

<sup>11</sup> See *Matthew Bender Ohio Transaction Guide*, §126.52.

<sup>12</sup> See FTC Summary of the Franchise Rule, 1 *CCH Business Franchise Guide* §6027 and ORC §1334.13(A). Franchisors relying on this exemption remain subject to the requirements of ORC §1334.03(H) and §1334.04.

<sup>13</sup> See text accompanying footnote 8, *supra*.

<sup>14</sup> See e.g. ORC §1334.12(I) (sale of existing business) and ORC §1334.12(L) (franchisor with large net worth) and ORC §1334.01 (D)(2).

<sup>15</sup> FTC Summary of the Franchise Rule, 1 *CCH Business Franchise Guide* §6026.

<sup>16</sup> ORC §1334.13(B).

<sup>17</sup> Proposed revisions to the NASAA Uniform Franchise Offering Circular, July 22, 1992.

<sup>18</sup> 1 *CCH Business Franchise Guide* §5821.

<sup>19</sup> 1 *CCH Business Franchise Guide* §6120. See also footnote 443 and accompanying text, Federal Trade Commission statement of Basis and Purpose, 1 *CCH Business Franchise Guide* §6337.

<sup>20</sup> ORC §1334.09 and see, e.g., *Holloway v. Bristol Myers Corp.*, 485 F2d 986 CCADC, 1973); *Olivieri v. McDonald's Corporation*, 678 F. Supp 996, 1000 n.2 (EDNY, 1990).

<sup>21</sup> ORC §1334.13.

<sup>22</sup> Franchise Disclosure and Consumer Protection Act, H.R. 5232, 102d Cong., 2d Sess. (1992.) Federal Fair Franchising Practices Act, H.R. 5961, 102d Cong., 2d Sess. (1992).