Hidden Franchise Fees: Seeking a Rational Paradigm

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The franchise fee requirement is well-traveled territory in the franchise and distribution arenas.[1] Yet, determining whether a particular expenditure constitutes a "franchise fee" under federal law or under one or more of the applicable state laws can be a somewhat unpredictable exercise. When will a payment be deemed an "ordinary business expense," rather than a franchise fee? How can a distributor demonstrate that the price it charged to its dealers was a "bona fide wholesale price" that did not include an indirect or "hidden" franchise fee? At what stage of litigation will a court be willing to make this determination? How does the particular language in each statute affect the outcome?

For those U.S. jurisdictions that have defined the term "franchise" under a franchise disclosure or franchise relationship law, the inclusion of some fee element is nearly universal.[2] This fee element—a required payment from the franchisee to the franchisor for the right to conduct business—is typically one of three required elements in a definitional statute or regulation, and is defined to include both direct and indirect payments. The ability to demonstrate that a particular payment does or does not qualify as a "franchise fee" under the applicable laws often determines whether a business will be regulated as a franchise, with all of the attendant costs, liabilities, and operational restrictions, or will operate as part of a distribution model outside the scope of the franchise laws.

1. *See, e.g.*, David Gurnick, Jeffery S. Haff & Craig Miller, *Franchising—Litigating the Definitional Elements*, ABA 41st Annual Forum on Franchising, W-8 (Oct. 10–12, 2018); Ann Hurwitz & David W. Oppenheim, *You Don't Want to Be a Franchise? Structuring Business Systems Not to Qualify as Franchises*, ABA 34th Annual Forum on Franchising, W-3 (Oct. 19–21, 2011); Jonathan Solish, *Unrecoverable Investments Define Franchise Relationship*, 26 Franchise L.J. 3 (2006); Rochelle Spandorf, *Structuring Licenses to Avoid the Inadvertent Franchise*, 2 Landslide 35 (Mar.–Apr. 2010).

2. State laws that define the term "franchise" without reference to any type of fee element or "community of interest" standard include the Arkansas Franchise Practices Act, Ark. Code Ann. § 4-72-202(1); the Connecticut Franchise Act, Conn. Gen. Stat. § 42-133e; and the Florida Franchise Act, Fla. Stat. § 817.416.

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Assuming that a non-franchised distribution business model is legitimately outside the reach of franchise laws, then ascertainable and predictable definitional guidance should be available to enable businesses—and those who counsel them—to assess, up front, the benefits and costs of such a distribution arrangement, compared to those of the franchise model. To that end, this article examines the existing statutory, regulatory, and case law establishing and applying the concept of a hidden or disguised franchise fee. After examining these legal sources, the article draws conclusions about what commonalities and patterns exist in distinguishing what is and is not a franchisee fee.

I. Why Does a Fee Matter?

A "franchise" is defined under most (but not all) franchise laws as a contract by which

1. a purchaser is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by the franchisor [or with the significant assistance from or under the control of the franchisor];
2. the business is substantially associated with the trademark, service mark, trade name, logotype, advertising, or other commercial symbol that designates the franchisor or its affiliate; and
3. the purchaser must pay, directly or indirectly, a franchise fee.

The first two elements—a marketing plan or system prescribed by the franchisor [or, alternatively, operation with significant assistance from or control by the franchisor] and a business operation that is substantially associated with the franchisor's brand—are generally considered descriptive of a franchise relationship and therefore necessary to distinguish a franchise from a non-franchised distribution arrangement. Not all legislatures have adopted the same formulation, however. The New York Franchise Sales Act, for example, reflects a legislative judgment that only one of these prongs, together with a franchise fee, is sufficient to constitute a franchise.[3] Alternatively, the Hawaii Franchise Investment Law bases its definition of "franchise" on the grant of a license to use a trade name in which there is a "community interest in the business of offering, selling, or distributing goods or services," together with a franchise fee.[4]

But nearly all franchise statutes and regulations—and every one that establishes a state franchise registration process—include the requirement that the franchisee pay a franchise fee. This is no coincidence. The presence of a fee requirement dictates which business arrangements are deemed to be in need of legislative intervention and which are not.

3. N.Y. Gen. Bus. Law § 681(3).
4. Haw. Rev. Stat. § 482E-2.

Legislative histories and rulemaking proceedings for franchise laws consistently cite as their inspiration a need to protect vulnerable franchisees. Some legislative and rulemaking bodies have provided this protection in the form of comprehensive and detailed disclosure requirements and, in some states, registration of franchise offerings.[5] Some states have enacted provisions that protect franchisees by restricting certain post-contract policies and practices, such as termination, non-renewal, and certain dispute resolution provisions (*e.g.*, choice of law, choice of forum, attorney fee shifting).[6]

The rationale for limiting the reach of these protective laws to only those franchisees who have paid a franchise fee has been examined extensively. In its Statement of Basis and Purpose accompanying adoption of the original federal Franchise Disclosure Rule, the Federal Trade Commission (FTC) stated:

> [T]he rule should focus upon those franchisees who have made a personally significant monetary investment and who cannot extricate themselves from the unsatisfactory relationship without suffering a financial setback. Implicit in the concept of franchising, as viewed by the Commission, is the assumption of a financial risk by a franchisee in entering into a franchise relationship. . . . Where a franchisee makes no significant investment in the franchise business, he assumes only a limited risk, and the protection of the rule is inappropriate.[7]

Courts have echoed this rationale. In *Wright-Moore Corp. v. Ricoh Corp.*, the Seventh Circuit observed that "[t]he reason for the franchise fee requirement . . . is to insure that only those entities that have made a firm-specific investment are protected under the franchise laws; where there is no investment, there is no fear of inequality of bargaining power."[8] Consistent with this principle, and relying on language used in other cases,[9] the *Wright-Moore* court reasoned that only investments that are "unrecoverable" and are made "for the right" to conduct business under the franchisor's brand should be deemed to be franchise fees sufficient to subject a business relationship to regulation as a franchise.[10] By contrast, expenditures that are "recoverable" or can be considered "ordinary business expenses" should not be considered franchise fees.[11]

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5. *See*, *e.g.*, Cal. Corp. Code § 31000 *et seq*.; Wash. Admin. Code § 460-80-050 *et seq*.
6. *See*, *e.g.*, N.J. Stat. Ann. § 56:10-1 *et seq*.
7. 43 Fed. Reg. 59704 (Dec. 21, 1978).
8. 908 F.2d 128, 135–36 (7th Cir. 1990); *see also* Thueson v. U-Haul Int'l, Inc., 50 Cal. Rptr. 669, 675 (Ct. App. 2006); JJCO, Inc. v. Isuzu Motors Am., Inc., 2009 WL 1444103, at *4 (D. Haw. May 22, 2009), *aff'd*, 2012 WL 2584294 (9th Cir. July 5, 2012).
9. In Bruce Napell's article, *States' Definitions of Franchise Relationship Not Uniform*, 26 Franchise L.J. 3 (2006), the author criticized the *Wright-Moore* decision, arguing that the court had improperly applied the standard for minimum investment associated with "community of interest" statutes to a "franchise fee" statute. The distinction drawn between these types of statutes was explicitly rejected in *Adees Corp. v. Avis Rent-A-Car System, Inc.*, Bus. Franchise Guide (CCH) ¶ 12,702 at n.2 (C.D. Cal. Nov. 19, 2003), *aff'd*, 157 F. App'x 2 (9th Cir. 2005), and has not been evident in other decisions.
10. *Wright-Moore*, 908 F.2d at 136.
11. *Id.*

In *Adees Corp. v. Avis Rent-A-Car System, Inc.*, the United States District Court for the Central District of California interpreted the California Franchise Relations Act and articulated three "interrelated factors" that courts in various jurisdictions have considered "in determining whether a particular payment is a franchise fee":

> (1) whether the party making the payment received something of value in exchange for the fee; (2) whether the payment was an ordinary business expense or an unrecoverable investment; and (3) whether the party making the payment put its own money at risk.[12]

Thus, the franchise fee requirement is closely tied to the goal of protecting those franchisees who have made a significant and unrecoverable investment in the franchised business. This background is important for understanding and examining how courts have applied these standards.

II. When Is a Payment Not a Franchise Fee?

There is no question that a fee that a franchisee is required to pay (or, in some cases, agrees to pay) to the franchisor or its affiliate for the right to operate a business is a "franchise fee." There is no real dispute that a direct franchise fee—such as an upfront fee or a royalty in exchange for the right to conduct the business—will meet every statutory definition of a franchise fee. The challenge is in determining whether, when, and in what jurisdictions an indirect fee, which usually presents itself as a charge for goods or services provided to the franchisee, will be deemed a franchise fee.

A. *A Franchise Fee by Any Other Name . . .*

A franchise agreement is a contract, albeit a specialized and highly regulated one. A basic principle of contract law is that the parties' intent matters.[13] In keeping with the regulatory goal of protecting the consumer against overreaching, courts routinely recite that the designation given by the parties to the contract or the fee is not dispositive of their true legal relationship.[14] Indeed, the FTC and several states have included language in their franchise laws disclaiming reliance on the parties' expressed intent.[15]

12. *Adees Corp.*, Bus. Franchise Guide (CCH) ¶ 12,702.

13. *See* LJL Transp., Inc. v. Pilot Air Freight Corp., 962 A.2d 639, 647–48 (Pa. 2009).

14. *See* To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc., 152 F.3d 658, 662–63 (7th Cir. 1998) (applying Illinois law); H.C. Duke & Son, LLC v. Prism Mktg. Corp., 2013 WL 5460209, at *8–9 (C.D. Ill. Sept. 30, 2013) (under Illinois and California law); SPX Corp. v. Shop Equip. Specialists, Inc., 2001 WL 36512993, at *10 (W.D. Mich. Mar. 28, 2001); Watkins & Sons Pet Supplies v. Iams Co., 107 F. Supp. 2d 883, 888 (E.D. Mich. 1999).

15. 16 C.F.R. § 436.1(h) ("any continuing commercial relationship or arrangement, whatever it may be called"); Haw. Rev. Stat. § 482E-2 ("whether or not referred to as royalty fees"); Ill. Admin. Code tit. 14, § 200.104 ("regardless of the designation given to … the fee"); S.D. Codified Laws § 37-5B-1(11) ("any continuing commercial relationship or arrangement, whatever it may be called"); Wash. Rev. Code § 19.100.010(8) ("whether or not referred to as royalty fees"); State of California, Dep't of Corps., Release 3-F, *When Does an Agreement Constitute a Franchise*, at 8 (June 22, 1994) ("regardless of the designation given to . . . such payment").

Courts do occasionally cite contractual language that explicitly disavows the intent to create a franchise relationship as persuasive (although usually not dispositive) evidence that the parties did not intend a certain payment to constitute a franchise fee.[16] For example, in *Ward's Equipment, Inc. v. New Holland North America, Inc.*, the Virginia Supreme Court rejected a dealer's claim that its purchase of training videos and programs, payment for the use of cooperative advertising, and the purchase of certain goods from the manufacturer constituted an indirect franchise fee where "[t]hese factual assertions are directly contradicted by the contract [which] plainly states: 'The Dealer has not paid any fee for this agreement.'"[17]

In some cases, courts have relied on the presence—or absence—of an express justification or purpose for a payment within the contract when determining whether the payment is a franchise fee. In *Continental Basketball Ass'n, Inc. v. Ellenstein Enterprises, Inc.*, for example, the Indiana Court of Appeal concluded that a $300,000 purchase price for a professional basketball team, paid to the league, was a franchise fee. Observing that only part of the purchase price was reportable for tax purposes as compensation for the services of players under contract with other clubs, and that the league used the funds as working capital to pay its operating expenses, the court reasoned that the remainder must include payment for the right to operate a team associated with the league.[18] By contrast, in *Terra International v. Baker*, a federal district court rejected a claim that payments made by the plaintiff to a producer of specialized seed corn—including lump sum payments, $2 per-bag fees, and a royalty of four percent of the plaintiff's net sales—were indirect franchise fees. The court explained that "nowhere does the Agreement state that the payments made by [the dealer] were made for the right to market those goods or to enter the research business. Instead, the Agreement specifically provided one purpose for the payments: to fund Corn

16. *See* Engineered Sales Co. v. Endress + Hauser, Inc., 2019 WL 955074, at *5 (D. Minn. Feb. 27, 2019) (noting that "the Agreement establishes that parties did not intend to have franchisee/franchisor relationship" where the agreement identifies the dealer as an "independent sales representative" rather than as a franchisee); Prim LLC v. Pace-O-Matic, Inc., 2012 WL 6553819, at *5 (D. Haw. Dec. 14, 2012) (argument that relationship was a distributorship rather than a franchise is supported by the Distribution Agreement, which is "tellingly titled, 'Re: Distributorship'"); Kempner Mobile Elec., Inc. v. Southwestern Bell Mobile Sys., Inc., 2003 WL 22595263, at *7 (N.D. Ill. Nov. 7, 2003) ("Kempner's claim that it was a franchise flies in the face of the provision in the 1999 Agreement expressly stating that the relationship between the parties was not a franchise"), *aff'd*, 428 F.3d 706 (7th Cir. 2005); James v. Whirlpool Corp., 806 F. Supp. 835, 842 (E.D. Mo. 1992) (applying Michigan law) ("[n]owhere in the Agreement is the word franchise used").

17. Ward's Equip., Inc. v. New Holland N. Am., Inc., 493 S.E.2d 516, 521 (Va. 1997). *But see* Three M Enters., Inc. v. Texas D.A.R. Enters., Inc., 368 F. Supp. 2d 450 (D. Md. 2005) ("Defendants have cited no authority suggesting that the terms of the form agreement control in light of contrary factual allegations.").

18. Continental Basketball Ass'n, Inc. v. Ellenstein Enters., Inc., 640 N.E.2d 705, 709 (Ind. Ct. App. 1994), *aff'd in relevant part*, 669 N.E.2d 134 (Ind. 1996).

Research."[19] Thus, the court in *Terra International* declined to recharacterize those payments as indirect franchise fees.

B. *Statutory Inclusions and Exclusions*

Overall, there are more similarities than differences in the various federal and state laws defining the term "franchise fee." This congruity has been reinforced further by the common practice of courts relying on one another's interpretations and case law as persuasive authority.[20] Each franchise law first sets out a broad definition of the term "franchise fee," typically some version of the following: "any fee or charge," "direct or indirect," that a franchisee is required (or, in some cases, agrees) to pay to the franchisor or its affiliate "for the right" to operate the business. Many jurisdictions expressly include payments for "goods and services" within the definition of franchise fee, as well as payments made in any form (*e.g.*, lump sum, installments, periodic royalties, profits, or cash flow, or reflected in the price of goods, services, equipment, inventory or real estate sold by the licensor to the distributor or licensee). In addition, many jurisdictions include the requirement that a franchise fee be paid to the franchisor or an affiliate;[21] even where this is not specified, courts have consistently interpreted the franchise laws to impose such a requirement.[22]

Some statutory and regulatory variations can affect the outcome of a franchise fee analysis, by emphasizing certain types of payments that *should* be deemed franchise fees and/or by excluding certain types of payments that *should not* be deemed franchise fees, as discussed below:

19. Terra Int'l, Inc. v. Baker, Bus. Franchise Guide (CCH) ¶ 10,234 (D. Minn. Feb. 16, 1993); *see also* Nature's Plus Nordic A/S v. Natural Organics, Inc., 980 F. Supp. 2d 400, 416 (E.D.N.Y. 2013) (where a requirement that franchisee spend at least five percent of its purchases on advertising was expressly labeled "partial consideration" for a seventeen point five percent pricing discount, court concluded that the advertising requirement merely reduced the size of the discount and was not a franchise fee).

20. *See* Napell, *supra* note 9 ("Because franchise law . . . is based on a relatively small number of statutes and regulations, franchise lawyers and courts often rely on decisions from other jurisdictions to guide the interpretation of statutes in their own states. Decisions that follow this approach often justify it on the theory that 'most of the states' franchise laws appear to be quite similar.'") (citing cases); *cf.* To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc., 152 F.3d 658, 663 (7th Cir. 1998) (distinguishing Indiana law from Illinois law where, "unlike Illinois, Indiana had no administrative regulations broadly defining indirect franchise fees").

21. *See* 16 C.F.R. § 436.1 ("required payment to the franchisor or its affiliate"); 815 Ill. Comp. Stat. 705/3(1) ("required to pay to the franchisor or an affiliate of the franchisor"); Iowa Code § 537A.10c(1)(a)(ii) ("payment of a franchise fee to a franchisor or its affiliate"); Neb. Rev. Stat. § 87-402(1)(a) ("payment made by the franchisee to the franchisor"); Or. Rev. Stat. § 650.005(4)(c) ("required to give to the franchisor a valuable consideration"); R.I. Gen. Laws § 19-28.1-3(g) ("requires payment of a franchisee fee . . . to a franchisor or its affiliate"); S.D. Codified Laws § 37-5B-1(11) ("required payment to the franchisor or its affiliate").

22. *See*, *e.g.*, Sports Racing Serv., Inc. v. Sports Car Club of Am., Inc., 131 F.3d 874, 891–92 (10th Cir. 1997) (applying Indiana law) (purchase of business from predecessor is not a franchise fee, as "there is no indication that [the wholesaler] received any of this payment or otherwise benefitted from it"). California has expressed a possible exception to this general rule where a franchisee's payment to a third party for advertising and promotion may be deemed "for the account of the franchisor" and therefore a franchise fee if it is "to enhance the good will of the franchisor's business, even though the advertising and promotion also benefit the franchisee's business." Release 3-F, *supra* note 15, at 12.

1. Inclusions. In the absence of specific language to the contrary, a court may be persuaded to accept an argument that a particular payment is, for example, an "ordinary business expense" rather than a franchise fee;[23] however, the express inclusion of that type of payment as constituting a franchise fee under the jurisdiction's governing law would foreclose such a result. While numerous exclusions from the franchise fee definition are often carved out, comparatively few types of payments have been highlighted for special inclusion, perhaps because of the breadth of the general definition.

Several state laws specifically designate payments for training programs and/or materials as franchise fees.[24] Some jurisdictions note that a payment is a franchise fee, even if not required by contract, if the franchisor implies that it is necessary for success or if it is required as a practical matter.[25] Illinois specifically includes a transfer fee as a franchise fee, to the extent that it exceeds the reasonable expenses incurred in connection with the transfer.[26] Washington specifies that "any payment for goods or services available only from the franchisor" is a franchise fee.[27]

2. Exclusions. Nearly all jurisdictions that define the term "franchise fee" expressly exclude certain types of expenses from the definition.[28] These include, most notably, exclusions for the purchase of goods at a "bona fide wholesale price" and a fee deemed merely *de minimis*. The table below collects these exclusions.

23. *See* Section II.C., *infra*.

24. Haw. Rev. Stat. § 482E-2 ("any training fees or training school fees or charges"); Minn. Stat. § 80C.01 ("any training fees or training school fees or charges"); Va. Code Ann. § 13.1-559 ("a fee or charge for the right to enter into or maintain a business under a franchise, including a payment or deposit for . . . training"); Wash. Rev. Code § 19.100.010(8) ("any training fees or training school fees or charges"); Ill. Admin. Code tit. 14, § 200.106 ("Training programs are services and not goods regardless of whether offered, distributed or communicated by word of mouth, through instructions or lectures, in writing or printed form or by record or tape recording. If services are provided, an indirect franchise fee will be presumed regardless of whether the agreement sets forth an itemized fee for such services."); Mich. Admin. Code r. 445.101(2)(c) ("Payments for services . . . are presumed to be in part for the right granted to the franchisee to engage in the franchise business. Ideas, instruction, training, and other programs are services and not goods, irrespective of whether offered, distributed, or communicated by word of mouth, through instructions or lectures, in written or printed form, by record or tape recording, or any combination thereof.").

25. *See, e.g.*, 16 C.F.R. § 436.1(s) ("all consideration that the franchisee must pay . . . either by contract or by practical necessity"); S.D. Codified Laws § 37-5B-1(26) ("any consideration that the franchisee must pay . . . either by contract or by practical necessity"); Release 3-F, *supra* note 15, at 12 ("a payment by a franchisee, though nominally optional, may in reality be essential; this is especially so if the franchisor intimates or suggests that the payment is essential for the successful operation of the business").

26. Ill. Admin. Code tit. 14, § 200.104.

27. Wash. Rev. Code § 19.100.010(8). The same result—ensuring a market price—was achieved in Illinois by *excluding* equipment, materials, real estate services, or other items that can be purchased (and are available) from third parties from the definition of "franchise fee." Ill. Admin. Code tit. 14, § 200.105(c).

28. Of the jurisdictions that define the term "franchise fee," only Oregon and Utah contain no explicit exceptions to the definition. *See* Or. Rev. Stat. § 650.005; Utah Admin. Code R152-11-11.

Exclusions from Definition of "Franchise Fee"[29]

	De Minimis	Bona Fide Wholesale Price	Equipment, Fixtures, and Supplies	Rent or Purchase of Real Property	Bona Fide Loan to Franchisee	Promotional Supplies (Not for Resale)	Surety Bond or Deposit
FTC	$500 within first 6 months	Inventory for resale or lease					
CA	$100/$500	Goods/ Inventory	$1,000/year, at FMV				
DE	$100						
HI		Goods	FMV	FMV	X		
IL	$500	Goods for resale	Yes, if not req'd or available from other sources	Economic value			
IN		Goods					
IA		Goods for resale	FMV	FMV	X	FMV	
MD	$100	Goods	FMV	FMV	X	At cost	
MI		Goods	Bona fide wholesale price	FMV			
MN	$100/year	Goods	FMV	FMV	X		
MS	$100/year					At cost	
NE		Goods or services[30]					X
NY	$500/year for value	Goods		FMV		At cost	
ND		Goods					
RI	$500	Goods for resale					
SD	$500 within first 6 months	Inventory for resale or lease					
VA	$500	Inventory for resale	FMV	FMV			
WA	$500	Goods	FMV	FMV	X		
WI		Goods	FMV	FMV	X		

[FMV=Fair Market Value]

29. *See* 16 C.F.R. §§ 436.1(s); 436.9; Cal. Bus. & Prof. Code § 20007; Cal. Corp. Code § 31011; Cal. Code Regs. tit. 10, §§ 310.011, 310.011.1; Del. Code Ann. tit. 6, § 2551; Haw. Rev. Stat. § 482E-2; 815 Ill. Comp. Stat. 705/3(14); Ill. Admin. Code tit. 14, § 200.105; Ind. Code § 23-2-2.5-1(i); Iowa Code § 537A.10.d; Md. Code Ann. Bus. Reg. §§ 14-201(f), 14-203; Md. Code Regs. 02.02.08.10.C; Mich. Comp. Laws § 445.1503(3)(1); Mich. Admin. Code r. 445.101(2), (6); Minn. Stat. § 80C.01, subd. 4(c), subd. 9; Miss. Code Ann. § 75-24-51(7); Neb. Rev. Stat. § 87-402(5); N.Y. Gen. Bus. Law § 681(7); N.D. Cent. Code § 51-19-02(6); R.I. Gen. Laws § 19-28.1-3(g), (h); S.D. Codified Laws §§ 37-5B-1(26); 37-5B-12(5); Va. Code Ann. § 13.1-559; Wash. Rev. Code §§ 19.100.010(8); 19.100.030(4); Wis. Stat. § 553.03(5m); Wis. Admin. Code DFI § 31.01(1)(b).

30. The Nebraska Franchise Practices Act excludes from the definition of "franchise fee" the purchase of any goods or services from a franchisor, without requiring that the purchase be at a bona fide wholesale price. Neb. Rev. Stat. § 87-402(5).

C. *An Ordinary Business Expense or a Fee for the Right to Conduct Business?*

An examination of case law pertaining to indirect franchise fees shows extensive use of the term "ordinary business expense" by the courts, usually to denote an expense that is *not* an indirect franchise fee. Yet none of the statutes or regulations defining the term "franchise fee" features the term "ordinary business expense." The term seems to have originated from the United States District Court for the District of Minnesota, in *Siedare Associates, Inc. v. Amperex Sales Corp.*[31] There, an independent sales representative, Siedare, alleged that its contract had been unlawfully terminated by Amperex, the supplier, in violation of the Minnesota Franchise Act. The dispute centered on the nature of the relationship or, more precisely, whether the sales representative had paid Amperex a "franchise fee" within the meaning of the statute.[32] The sales representative alleged that four different expenditures constituted "franchise fees" under the Minnesota Franchise Act:

1. Charges for transportation, some meals, and incidental expenses incurred in sending Siedare's employees to Amperex's sales meetings;
2. Amounts debited to Siedare's commission account for commissions previously paid and with respect to which Amperex has not received payment from the customer or with respect to which the products sold were returned by the customer;
3. Charges for the mailing of Amperex promotional literature; and
4. Expenses incurred in assisting Amperex in collecting its delinquent accounts.[33]

The court granted summary judgment in favor of Amperex, on the ground that all of the claimed expenditures "are merely ordinary business expenses necessarily incurred by Siedare in conducting its business as a sales representative."[34] The brief opinion provided minimal analysis and merely observed that "[t]o adopt Siedare's interpretation would subject every sales representative relationship to all the requirements of the Franchise Act, a result which does not comport with the letter or the spirit of the Franchise Act."[35]

The *Siedare* court's reasoning supports the position that any expenses that a sales representative would have incurred anyway—absent any type of ongoing relationship with a supplier—should not be deemed franchise fees. Other courts have adopted this reasoning, with some explicitly tying this idea to the requirement—found in virtually all franchise statutes—that a franchise fee be in exchange for the right to conduct business with the supplier or under the supplier's brand. In *JJFCO, Inc. v. Isuzu Motors America, Inc.*, for example, a federal district court considered whether the manufacturer's

31. Siedare Assocs., Inc. v. Amperex Sales Corp., Bus. Franchise Guide (CCH) ¶ 7732 (D. Minn. July 20, 1981).
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.*

requirement that a dealer purchase certain communications software constituted a franchise fee.[36] The court observed that "[i]f [the dealer] would have incurred some or all of the same communications system expense regardless of the nature of its agreement with the manufacturer, then it is difficult to see how the expense was one incurred for the right to do business with [the manufacturer]."[37]

A similar line of reasoning has been applied by some courts, particularly those applying the Minnesota Franchise Act. According to those courts, if an expense is "reasonable" and there is a "valid business purpose" for it, then it is an "ordinary business expense," rather than a franchise fee.[38] In *Day Distributing Co. v. Nantucket Allserve, Inc.*, soft drink distributors asserted that certain marketing expenses, discount pricing programs, and minimum-purchase requirements imposed by the supplier were franchise fees, entitling them to the protection of the Minnesota Franchise Act. A federal district court disagreed, due to the lack of evidence that the programs at issue were unreasonable or lacked a valid business purpose.[39] Regarding the marketing and discount programs, the court observed that, because "[n]ot every marketing program produces immediate profits," the mere fact that a distributor

36. JJCO, Inc. v. Isuzu Motors Am., Inc., 2009 WL 1444103, at *8 (D. Haw. May 22, 2009).

37. *Id.*; *see also* Atchley v. Pepperidge Farm, Inc., 2012 WL 6057130, at *9 (E.D. Wash. Dec. 6, 2012) ("Ordinary business expenses are not franchise fees because they are paid during the regular course of business, not as a right to do business."); Roberts v. C.R. England, Inc., 827 F. Supp. 2d 1078, 1085 (N.D. Cal. 2011) (payments for training, truck rental, computer rental, operational equipment, insurance, signs, maintenance, gas promotional materials, and other items were ordinary business expenses and not disguised franchise fees); Thueson v. U-Haul Int'l, Inc., 50 Cal. Rptr. 669, 675 (Ct. App. 2006) (expenses were "nothing more than ordinary business expenses and not an investment required by [the dealer] for the right to operate a dealership"); Romeo Maint. & Rental v. U-Haul Co. of Minn., Bus. Franchise Guide (CCH) ¶ 12,322 (Minn. Dist. Ct. Apr. 25, 2002) (fact question as to whether dealer would have incurred telephone and computer expenses if it operated independently precluded motion to dismiss); Bryant Corp. v. Outboard Marine Corp., 1994 WL 745159, at *2 (W.D. Wash. Sept. 29, 1994), *aff'd*, 77 F.3d 488 (9th Cir. 1996) (business taxes are ordinary business expenses "no matter who paid them"; ultimate beneficiary is the State of Washington); Premier Wine & Spirits of S.D., Inc. v. E. & J. Gallo Winery, 644 F. Supp. 1431, 1438 (E.D. Cal. 1986) (applying now repealed and replaced version of South Dakota Franchise Act to hold that wages paid to employees are ordinary business expenses, not payments for the right to do business), *aff'd*, 846 F.2d 537 (9th Cir. 1988).

38. *See* Clear Wave Hearing Instruments, Inc. v. Starkey Holding Corp., 2012 WL 949953, at *7 (D. Minn. Mar. 20, 2012) (minimum purchase requirements, training fees, and advertising fees were not franchise fees absent evidence they were unreasonable and lacked a valid business purpose); R&A Small Engine, Inc. v. Midwest Stihl, Inc., 2006 WL 3758292, at *4 (D. Minn. Dec. 20, 2006) (regional advertising fee was a "reasonable and ordinary business expense that directly benefited [the dealer]," rather than a franchise fee); Upper Midwest Sales Co. v. Ecolab, Inc., 577 N.W.2d 236, 242 (Minn. Ct. App. 1998) (reasonable minimum-purchase requirements and payments for business assets were not franchise fees); Banbury v. Omnitrition Int'l, Inc., 533 N.W.2d 876, 882 (Minn. Ct. App. 1995) (reasonable minimum-purchase requirements were not franchise fees); OT Indus., Inc. v. OT-tehdas Oy Santasalo-Sohlberg AB, 346 N.W.2d 162, 166–67 (Minn. Ct. App. 1984) (reasonable minimum purchase requirement did not lack a valid business purpose and therefore was not a franchise fee); RJM Sales & Mktg., Inc. v. Banfi Prods. Corp., 546 F. Supp. 1368, 1373 (D. Minn. 1982) (payments for wine samples and jackets and a lower than average commission were ordinary business expenses rather than franchise fees).

39. Day Distrib. Co. v. Nantucket Allserve, Inc., 2008 WL 2945442, at *5–6 (D. Minn. July 25, 2008). Significantly, the *Day* court granted summary judgment in the supplier's favor, finding the lack of evidence so compelling that no reasonable jury could find otherwise.

lost money on some of the programs did not create a jury question on the reasonableness of the program.[40] Likewise, no jury question was presented where a distributor had routinely sold inventory in excess of the required minimum (even though it was left with hundreds of unsold cases at the time of termination).[41] Recently, in *Louis DeGidio, Inc. v. Industrial Combustion, LLC*, the United States District Court for the District of Minnesota reaffirmed the principle that "ordinary business expenses are not considered franchise fees unless they are unreasonable and lack a valid business purpose" and rejected a distributor's claim that reasonable minimum inventory requirements were franchise fees.[42] This "valid business purpose" reasoning has been adopted only on a limited basis outside of Minnesota, although it does not appear to be based on any anomaly of Minnesota law.[43]

Two types of expenses—those relating to training and those relating to advertising, marketing, and promotion—appear frequently in the case law and offer some insights into how courts have distinguished between a "franchise fee" and an "ordinary business expense." These cases are discussed below.

1. Training Fees and Expenses

Several states have specifically included training fees within the definition of "franchise fees" in their statutes or regulations.[44] Nevertheless, unless training is mandatory, and the fee must be paid to the supplier or its affiliate, courts typically will not consider training fees to be an indirect franchise fee.[45] Expenses incurred in connection with training, such as for travel, accommodations, or meals, but not paid to the franchisor or its affiliate, have consistently been deemed to be ordinary business expenses and not franchise fees.[46]

Courts sometimes distinguish between fees for live training (which are usually deemed to be services and therefore outside of the bona fide wholesale price exception) and expenses for training videos, manuals, or other materials (which can sometimes, but not always, fall within a bona

40. *Id.* at *6.

41. *Id.*

42. Louis DeGidio, Inc. v. Indus. Combustion, LLC, 2019 WL 6894437, at *3 (D. Minn. Dec. 18, 2019).

43. In holding that the dealer made no showing that its marketing expenses were unreasonable or a firm-specific investment, the Hawaii district court in *JJCO, Inc. v. Isuzu Motors America, Inc.*, 2009 WL 1444103, at *9 (D. Haw. May 22, 2009), cited the *Day* court's holding that an expense that is neither unreasonable nor lacking a valid business purpose does not rise to the level of a franchise fee.

44. *See supra* note 24.

45. *Louis DeGidio, Inc.*, 2019 WL 6894437, at *4; Rogovsky Enters., Inc. v. Masterbrand Cabinets, Inc., 2015 WL 7721223, at *7 (S.D. Ind. Nov. 30, 2015); Hogin v. Barnmaster, Inc., 2003 WL 21500044, at *5 (Minn. Ct. App. July 1, 2003); DuPage Fork Lift Serv., Inc. v. Mach. Distrib., Inc., 1995 WL 125774, at *6 (N.D. Ill. Mar. 15, 1995).

46. Schultz v. Onan Corp., 737 F.2d 339, 344–45 (3d Cir. 1984) (applying Minnesota law); Implement Serv., Inc. v. Tecumseh Prods. Co., 726 F. Supp. 1171, 1179 (S.D. Ind. 1989).

fide wholesale price exception if they are priced at fair market value).[47] In *JJCO, Inc. v. Isuzu Motors America, Inc.*, for example, a federal district court was unable to determine, as a matter of law, whether the dealer had paid an indirect franchise fee based on an invoice for training expenses, where the record did not disclose if the expenses were for training sessions (which would constitute franchise fees) or for training materials (which may not).[48] Manufacturers and licensors are advised to pay particular attention to the statutes and regulations applicable to the state or states where their dealers operate, specifically whether training fees are specifically denominated as indirect franchise fees and, if so, what types of training expenses are covered.

2. Advertising, Marketing, and Promotional Expenses

If a marketing program is optional, which may be demonstrated by evidence of less than full system participation or a lack of penalties for nonparticipating franchisees, most courts will consider the associated expenses to be ordinary business expenses rather than franchise fees.[49] A note of caution: the term "optional" is subject to a broad spectrum of interpretations. For example, in *Inland Printing Co. v. A.B. Dick Co.*, the purchase of advertising materials from a manufacturer was deemed to be optional, despite a requirement that the dealer "utilize" the manufacturer's materials, on the ground that many materials were made available for free and the dealer could have developed its own materials.[50] Conversely, a California administrative guidance document states that "a payment by a franchisee, though nominally optional, may in reality be a required one, if the article for which the payment is made is essential, or if the franchisor intimates or suggests that it is essential, for the successful operation of the business."[51]

47. *See* Section II.E. *infra*.

48. JJCO, Inc. v. Isuzu Motors Am., Inc , 2009 WL 1444103, at *10–11 (D. Haw. May 22, 2009).

49. Rolscreen Co. v. Pella Prods. of St. Louis, Inc., 64 F.3d 1202, 1209 (8th Cir. 1995) (applying Illinois law) (dealer was not required to install supplier's windows in its new stores, even though dealer used them as product displays); Kenaya Wireless, Inc. v. SSMJ, LLC, 2009 WL 763496, at *2 (Mich. Ct. App. Mar. 24, 2009) (monthly marketing payments were not required where most other franchisees chose not to participate in marketing program); Day Distrib. Co. v. Nantucket Allserve, Inc., 2008 WL 2945442, at *6–7 (D. Minn. July 25, 2008) (fact that some dealers declined to participate in certain promotions supported conclusion that participation was not required); Freudenberg Build. Sys., Inc. v. Architectural Floor Sys., Inc., 1995 WL 598827, at *6 (D. Mass. Oct. 3, 1995) (applying Illinois law) (no franchise fee where distributorship agreement required supplier to provide promotional materials at no cost); Lafayette Beverage Distrib., Inc. v. Anheuser-Busch, Inc., 545 F. Supp. 1137, 1150–51 (N.D. Ind. 1982) (noting that $4,000 advertising payment was voluntary and therefore not a franchise fee where the supply of products was not conditioned on the distributor's agreement to advertise).

50. Inland Printing Co. v. A.B. Dick Co., Bus. Franchise Guide (CCH) ¶ 8997 (W.D. Mo. Mar. 18, 1987) (applying Illinois law).

51. Release 3-F, *supra* note 15, at 12; *see also* Boat & Motor Mart v. Sea Ray Boats, Inc., 825 F.2d 1285, 1289–90 (9th Cir. 1987) (applying California law) (purchase of promotional materials was required because they were suggested by the manufacturer as essential).

Advertising expenses that are paid to a third party, rather than directly to a franchisor, are generally not deemed to be franchise fees.[52] Even some advertising expenses paid directly to a manufacturer may be considered to be outside the definition of a franchise fee if the funds are deemed to benefit the dealers themselves rather than the manufacturer. In *R&A Small Engine, Inc. v. Midwest Stihl, Inc.*, for example, a federal district court rejected a dealer's claim that its required one percent contribution to the regional advertising fund was a franchise fee, even though it was paid into a fund maintained by the manufacturer.[53] The court reasoned that because the manufacturer received no income from the fund, the dealers were the exclusive beneficiaries and therefore the payments were ordinary business expenses and not franchise fees.[54] A notable exception to this rule is found in California, where administrative guidance provides that:

> payments required in the franchise agreement to be made by the franchisee for advertising and promotion to enhance the good will of the franchisor's business, even though the advertising and promotion also benefit the franchisee's business, may be deemed made for the account of the franchisor, especially where the agreement gives the franchisor discretion to determine the manner and content of the publicity.[55]

Promotional expenditures that courts determined were either voluntary or would have been incurred in the absence of a franchise relationship have been deemed ordinary business expenses, rather than franchise fees. These have included yellow page listings;[56] advertising materials that a dealer purchased from a manufacturer instead of developing itself;[57] and advertising purchased in furtherance of the dealer's obligation to "effectively promote sales."[58] In addition, some courts have held that advertising payments, like other payments, are not franchise fees unless they are "unreasonable" and lack a "valid business purpose."[59]

Other courts have concluded that a dealer's advertising expenses did (or may) constitute franchise fees.[60] In *Bly & Sons, Inc. v. Ethan Allen Interiors*,

52. *OT Indus., Inc.*, 346 N.W.2d at 167; *Implement Serv.*, 726 F. Supp. at 1178–79.

53. R&A Small Engine, Inc. v. Midwest Stihl, Inc.,2006 WL 3758292, at *4 (D. Minn. Dec. 20, 2006).

54. *Id.*; *see also OT Indus., Inc.*, 346 N.W.2d at 167 (where dealer is required to "effectively promote sales," but there is no required dollar amount or reserved right of approval in the manufacturer, the direct beneficiary of the advertising expenses is the dealer).

55. Release 3-F, *supra* note 15, at 12.

56. *R&A Small Engine*, 2006 WL 3758292, at *4 (D. Minn. Dec. 20, 2006).

57. *Inland Printing Co.*, Bus. Franchise Guide (CCH) ¶ 8997.

58. *OT Indus., Inc.*, 346 N.W.2d at 167 (where there is no required dollar amount specified and the manufacturer does not reserve a right of approval, the advertising expenditures are ordinary business expenses).

59. *See* Day Distrib. Co. v. Nantucket Allserve, Inc., 2008 WL 2945442, at *5 (D. Minn. July 25, 2008).

60. *See* H.C. Duke & Son, LLC, 2013 WL 5460209, at *9 (C.D. Ill. Sept. 30, 2013) (allegation that dealer paid distributor for advertising and promotional materials is sufficient to survive motion to dismiss); Pool Concepts, Inc. v. Watkins, Inc., Bus. Franchise Guide (CCH) ¶ 12,249 (D. Minn. Jan. 29, 2002) (even though it is the manufacturer that deposits money into a co-op fund, the money comes from a markup in the sale of spas to dealers); Tractor & Farm Supply,

Inc., the court opined that "[i]t is one thing . . . for [a dealer] to incur some advertising expenses as an ordinary business expense; it is another for [the manufacturer] to require its dealers to pay a percentage of their invoices into a common advertising fund."[61]

D. *Something of Value or Unrecoverable Investment*

Another concept that courts have applied in determining whether a payment is a franchise fee or an ordinary business expense is whether the dealer received something of value from the supplier in exchange for the payment. If so, the reasoning goes, the dealer has not made a "firm-specific" or "unrecoverable" investment that would weaken its bargaining position vis-à-vis the supplier (and is therefore not in need of special protection), and the payment cannot have been for the right to conduct the business (assuming that the item was purchased at or below market price). As one federal district court recently observed in *Louis DeGidio*, "The essence of a franchise fee is the franchisee paying something of value to the franchisor."[62]

In *Adees Corp. v. Avis Rent-A-Car System, Inc.*, a federal district court considered whether a 20¢-per-day-per-vehicle "fleet surcharge" (which was well below the cost to the supplier of maintaining the fleet) and a refueling charge, which were subtracted from the commission due to the dealer, constituted indirect franchise fees under the California Franchise Relations Act. Finding that the dealer received "something of value" in return for the surcharge—use of "a fleet of vehicles to give [the dealer] the ability to conduct the rental business"—the court held that the surcharge was merely an ordinary business expense and not a franchise fee.[63] The refueling charge, a thirty-five percent fee on all fuel revenue, was characterized as simply part of a valid commission structured by the parties, not a hidden franchise fee.[64] Because the value received by the dealer exceeded the fees deducted from its commission, they did not constitute franchise fees.[65] Similarly, in evaluating required advertising expenditures that were claimed to be franchise fees, the federal district court in *Desert Buy Palm Springs, Inc. v. DirectBuy, Inc.* framed the issue as "whether the expenses paid were 'unreasonable' when compared

Inc. v. Ford New Holland, Inc., 898 F. Supp. 1198, 1204 (W.D. Ky. 1995) (applying Michigan law) (finding advertising, promotion, and sales materials to be a "service" and therefore constitute a franchise fee); Luzim v. Phillips, 1987 WL 30214, at *2 (E.D.N.Y. Dec. 10, 1987) (noting that claim survives motion to dismiss where "defendants have cited no New York case deciding that a payment of three percent into an advertising fund is not a franchise fee").

61. 2006 WL 2547202, at *3 (S.D. Ill. Sept. 1, 2006). The court offered no guidance on where to draw the line. Ms. Gibbs assisted in the representation of Ethan Allen in this matter.

62. Bly & Sons, Inc. v. Ethan Allen Interiors, Inc., 2019 WL 6894437, at *4 (D. Minn. Dec. 18, 2019).

63. Adees Corp. v. Avis Rent-A-Car System, Inc., Bus. Franchise Guide (CCH) ¶ 12,702 (C.D. Cal. Nov. 20, 2003), *aff'd*, 157 F. App'x 2 (9th Cir. 2005); *see also* Jon K. Morrison, Inc. v. Avis Rent-A-Car Sys., Inc., 2003 WL 23119903, at *5–6 (W.D. Wash. Nov. 20, 2003) (fleet surcharge cannot be a franchise fee because it was not at an above-market price).

64. *Adees*, Bus. Franchise Guide (CCH) ¶ 12,702.

65. *Id.*

to the benefit received."[66] The court reasoned that "[r]etail companies must advertise in the ordinary course of business, so funds spent on advertising cannot constitute an indirect franchise fee unless the mandated expenditure is wholly disproportionate to the value received in exchange."[67] Finding no evidence that the dealer failed to benefit from its expenditures, the Desert Buy court held that the dealer did not adequately plead the existence of a franchise fee.[68] In *Wright-Moore*, another federal district court held that the training was not an "unrecoverable investment," and therefore not a franchise fee, because it was not "firm specific."[69] It based this conclusion on its finding that the dealer "failed to show that [manufacturer's] training was not transferable"—that is, useful to the dealer outside of its relationship with the manufacturer.[70] More recently, in *PW Stoelting, L.L.C. v. Levine*, a court rejected a claim that a minimum inventory purchase requirement constituted a franchise fee under the Washington Franchise Investment Protection Act, on the ground that the investment in inventory was "recoverable" through the promised repurchase by the supplier.[71]

Not all courts have been persuaded by this reasoning, particularly when applicable statutory or regulatory language speaks to the issue. A federal district court in *To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift America, Inc.* addressed this issue directly in determining whether payments for parts and repair manuals constituted franchise fees under the Illinois Franchise Disclosure Act.[72] While the court acknowledged the "logical force" of the manufacturer's argument that the dealer's purchase of the manuals, at market price, should not constitute a franchise fee because the dealer would receive something of value in return, applicable Illinois law plainly provided that all required payments to a manufacturer are franchise fees unless specifically excepted, and none of the available exceptions applied to manuals for use in the business (rather than for resale).[73] In affirming

66. Desert Buy Palm Springs, Inc. v. DirectBuy, Inc., 2011 WL 13224851, at *4 (C.D. Cal. Apr. 5, 2011) (citing cases from Minnesota, Illinois and Michigan for the same proposition).

67. *Id.* at *5.

68. *Id.* at *4–5.

69. Wright-Moore Corp. v. Ricoh Corp., 794 F. Supp. 844, 855 (N.D. Ind. Dec. 10, 1991), *aff'd*, 980 F.2d 432 (7th Cir. 1992).

70. *Id.*

71. 2018 WL 6603874, at *6 (E.D. Wis. Dec. 17, 2018); *see also* Sound of Music Co. v. Minn. Mining & Mfg. Co., 477 F.3d 910, 922 (7th Cir. 2007) (applying Minnesota law) (fee paid to supplier for satellite access is an ordinary business expense where there is no evidence that price was set above market rate); Kempner Mobile Elec., Inc. v. Sw. Bell Mobile Sys., LLC, 2003 WL 22595263, at *8 (N.D. Ill. Nov. 7, 2003) (repayments to supplier of an interest-free loan cannot constitute an unrecoverable investment), *aff'd*, 428 F.3d 706 (7th Cir. 2005); Corp. Res., Inc. v. Eagle Hardware & Garden Inc., 62 P.3d 544, 547–48 (Wash. Ct. App. 2003) (contractor's markup on subcontractor's installation charge is not an unrecoverable investment where subcontractor did not discount its price); *Cont'l Basketball Ass'n*, 640 N.E.2d at 709–10 (purchase price for basketball team is an unrecoverable investment where league retains significant control over sale of team).

72. PW Stoelting, LLC v. Levine, 953 F. Supp. 987 (N.D. Ill. 1997), *aff'd*, 152 F.3d 658 (7th Cir. 1998).

73. *Id.* at 991.

the district court's judgment, the Seventh Circuit held that the notion of an "unrecoverable investment"—first discussed in the context of Indiana law in *Wright-Moore*—was inapplicable in Illinois, in light of Illinois' more comprehensive regulations.[74]

E. *Purchase of Goods at a Bona Fide Wholesale Price*

The same reasoning that supports the argument that the purchase of something for value should not constitute a franchise fee also leads to the conclusion that the purchase of "goods" at a "bona fide wholesale price" does not constitute a franchise fee.[75] Nearly all franchise laws that define the term "franchise fee" expressly exempt from the definition the purchase of a reasonable quantity of "goods" at a "bona fide wholesale price," as long as there is no obligation to purchase an excessive amount.

1. Statutory Variations

There is a wide range of variations in the structure and detail that legislatures and rulemaking bodies have employed in establishing the "bona fide wholesale price" exception for the purchase of goods. Some jurisdictions use a minimalist approach, providing merely that the purchase of a "reasonable" quantity of "goods" at a "bona fide wholesale price" are not franchise fees, leaving the meaning of these terms open to interpretation.[76]

Some state laws define the term "goods," usually as inventory items that the dealer intends to resell (or lease) to third parties,[77] but in some cases more broadly, to include equipment and supplies. Other laws are silent on this point, leaving room for argument one way or the other.

In some cases, lawmakers have sought to define what is meant by a "reasonable" quantity of goods,[78] while others leave it to court interpretation. A handful of states have expanded on the term "purchase" by

74. To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc., 152 F.3d 658, 663 (7th Cir. 1998).

75. Release 3-F, *supra* note 15, at 9 ("no substantial prejudice will come to a person . . . paying only the bona fide wholesale price for merchandise which that person proposes to sell").

76. *See, e.g.*, 16 C.F.R. § 436.9(a); Ind. Code § 23-2-2.5-1; N.Y. Gen. Bus. Law § 681; S.D. Codified Laws § 37-5B-1.

77. 815 Ill. Comp. Stat. 705/3(14)(c) ("goods for which there is an established market"); R.I. Gen. Laws § 19-28.1-3(h)(3) ("tangible goods for resale"); Va. Code Ann. § 13.1-559 ("starting and continuing inventory of goods for resale"); Ill. Admin. Code tit. 14, § 200.106 (only goods for resale; not services, rental payments, or leases of real or personal property); Ill. Admin. Code tit. 14, § 200.107 (defines "established market"); Release 3-F, *supra* note 15, at 9 (only goods that franchisee is authorized to distribute).

78. Cal. Bus. & Prof. Code § 20007 ("if no obligation is imposed upon the purchaser to purchase or pay for a quantity of goods in excess of that which a reasonable businessperson normally would purchase by way of a starting inventory or supply or to maintain a going inventory or supply"); N.D. Cent. Code § 51-19-02(6)(a) (similar to California); Ill. Admin. Code tit. 14, § 200.108 ("a quantity of goods so unreasonably large that such goods may not be resold within a reasonable time . . . determined by the price, markup, consumer demand, location of product suppliers and seasonal demand variations").

including comparable transactions, such as consignment and commission arrangements.[79]

Variations on the meaning of a "bona fide wholesale price" are discussed below.

2. What Is a "Bona Fide Wholesale Price" or a "Market Price"?

By far the more interesting inquiry, particularly for a manufacturing business contemplating operation under a non-franchise distribution model, is how to set prices without undue risk of liability as an accidental franchise. This inquiry is relevant not only to the "bona fide wholesale price" exception, but also to the pricing of other items that many franchise laws exempt from the term "franchise fees"—such as fixtures and equipment, promotional materials, and real estate—if made available at a "fair market price," "bona fide wholesale price," or "for economic value."[80] Miscalculation potentially carries a very high price, usually long after effective adjustments can be made, yet clear guidance can be elusive.

a. *Statutory Guidance*

Several states provide explicit guidance regarding the meaning of a "bona fide wholesale price."[81] Some attempt to ensure a market-based price by calling for reliance on markets unrelated to the franchise system—an "open and public market" in California[82] and an "established market" in Illinois and Michigan,[83] for example.[84] Some explicitly recognize that a bona fide wholesale price should be measured in light of prices at a comparable level of distribution and that the bona fide wholesale price may be higher for branded goods than for non-branded goods.[85]

By contrast, some statutory directives counsel less reliance on market forces. Those jurisdictions that encourage reference to the seller's cost in determining whether a price is a bona fide wholesale price,[86] for example,

79. Haw. Code R. § 16-37-1; Md. Code Ann. Bus. Reg. § 14-201(f)(3); Mich. Comp. Laws § 445.1503; Minn. Stat. § 80C.01(9); Wash. Rev. Code § 19.100.010(8); Wis. Admin. Code DFI § 31.01.

80. *See* Exclusions from Definition of "Franchise Fee" table *supra* Section II.B.2.

81. *See*, *e.g.*, Release 3-F, *supra* note 15; Ill. Admin. Code tit. 14, § 200.106; Md. Code Regs. 02.02.08.03(C); Mich. Admin. Code r. 445.101(6).

82. Release 3-F, *supra* note 15, at 9–11.

83. Ill. Admin. Code tit. 14, § 200.107 ("established market"); Mich. Admin. Code r. 445.101(2)(e), (7) ("well-established market").

84. Illinois also specifically exempts from characterization as a franchise fee a payment made to the franchisor or an affiliate for equipment, materials, real estate services, or other items if either (a) "the purchase of the items is not required"; or (b) the "franchisee is permitted to purchase the items from sources other than the franchisor or its affiliates and the item is available from such other sources." Ill. Admin. Code tit. 14, § 200.105(c). Like the "established market" language, this section appears intended to bring market forces to bear in the pricing analysis.

85. Ill. Admin. Code tit. 14, § 200.106; Release 3-F, *supra* note 15.

86. Haw. Code R. § 16-37-1 (whether "the cost of goods, services, equipment, inventory, or real estate . . . to the seller . . . is reasonably related to the price of the same to the distributor or licensee, taking into account the respective circumstances in the market of both the seller and buyer thereof"); Md. Code Regs. 02.02.08.03(C) (whether "the cost to the seller of

may be implying that any price that provides too great a profit to a supplier is suspect, regardless of the market price. California's admonition that negotiability of a price may defeat a claim to the bona fide wholesale price exception, "since such sales prices will vary according to the ability of the purchaser to negotiate,"[87] similarly goes against the free-market grain.

The problem with untethering the notion of a bona fide wholesale price from market forces is that it leaves no discernible rules to guide application of the bona fide wholesale price exception. There is no inherent meaning associated with requiring a price to have a "reasonable relation" to the seller's cost or to say that "relevant cost information" may be considered. The hybrid approach taken by both Hawaii and Wisconsin—"the cost of goods, services, equipment, inventory, or real estate . . . to the seller . . . is reasonably related to the price of the same to the distributor or licensee, taking into account the respective circumstances in the market of both the seller and buyer thereof"[88]—is not any clearer. Using the seller's cost as a benchmark only serves as an invitation to agencies and factfinders to apply arbitrary standards that do not achieve the statutory aim of ensuring that dealers are paying fair market value. In *In re KIS Corp.*, for example, the hearing examiner opined, without reference to any evidence of market price, that a 100 percent markup was, on its face, inconsistent with the bona fide wholesale price exception.[89] Similarly, until recently, Washington's rule prohibiting a franchisor from selling any product or service to a franchisee at more than a "fair and reasonable price" had been interpreted to be amenable to arbitrary bright-line rules.[90] In *Money Mailer, LLC v. Brewer*, the Washington Supreme Court wisely reconnected the term to its market roots.[91]

b. *Case Law*

Not many courts have delved into an analysis of whether a price is a bona fide wholesale price or fair market value, let alone shared insights as to how

goods, services, equipment, inventory, or real estate is reasonably related to the price paid by the buyer"); Mich. Admin. Code r. 445.101(6) (relevant cost, marketing, pricing, or payment information, among other factors, may be considered); Wis. Admin. Code DFI § 31.01(7)(c) (whether "the cost of goods, services, equipment, inventory, or real estate . . . to the seller . . . is reasonably related to the price of the same to the distributor or licensee, taking into account the respective circumstances in the market of both the seller and buyer thereof").

87. Release 3-F, *supra* note 15, at 9–11.

88. Haw. Code R. § 16-37-1; Wis. Admin. Code DFI § 31.01(7)(c).

89. *In re* KIS Corp., Bus. Franchise Guide (CCH) ¶ 8731 (Wis. Secs. Comm'r Dec. 24, 1986).

90. *See* Money Mailer, LLC v. Brewer, 449 P.3d 258 (Wash. 2019) (interpreting Rev. Code Wash. § 19.100.180(2)(d) on certified questions from United States District Court for the Western District of Washington). In addition, the Securities Division of the Washington Department of Financial Institutions, which administers the state's franchise registration process, had routinely rejected franchise registration applications if the franchisor indicated in Item 8 of its Franchise Disclosure Document that it intended to apply more than a twenty percent markup on products or services sold to franchisees, on the ground that any markup over twenty percent would presumptively exceed a "fair and reasonable" price.

91. *Money Mailer*, 449 P.3d at 267–68 (explicitly rejecting the contention that a markup of 100 percent was unreasonable as a matter of law).

they reached their conclusions. What case law exists, however, is instructive. Below are some general observations.

Several courts that have addressed the issue have concluded that a supplier's markup does not, by itself, demonstrate that the price exceeds the bona fide wholesale price or fair market value.[92] Factors that have weighed in favor of a finding that a supplier's price is set at or below the bona fide wholesale price include whether a manufacturer sold goods below its own cost[93] and whether a dealer was able to make a profit.[94] In some jurisdictions, if a subcontractor performs work at its usual price, the fact that the supplier also earned a profit on the transaction will not support a finding that the dealer effectively paid an indirect franchise fee.[95]

A price that is determined based on a percentage of sales, rather than on characteristics of the item being sold, has been deemed suspect. In *Corp v. Atlantic-Richfield Co.*, a lease arrangement that included rent in the amount of ten percent of the mini-market operator's gross sales, with a specified minimum rent, constituted an indirect franchise fee under the Washington Franchise Investment Protection Act.[96] This conclusion was supported by the fact that all operators paid the same rent, without regard to the fair market or rental value of the property.[97]

If there is an applicable statutory or regulatory provision that addresses the precise issue, it will control. In *To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift America, Inc.*, the Seventh Circuit rejected the supplier's argument that the manuals it sold to the dealer were not an indirect franchise fee because they were sold at a bona fide wholesale price.[98] Because the Illinois Franchise Disclosure Act explicitly ties its bona fide wholesale exception to the existence of an "established market" in the goods, and because there was

92. *See Prim LLC*, 2012 WL 6553819, at *5 (noting that supplier's "profit margin is not proof that [dealer's] payment . . . constituted a franchise fee. Hawaii law does not provide that a distributor's profit on a distributorship agreement transforms a relationship into a franchise"); Kenaya Wireless, Inc. v. SSMJ, LLC, 2009 WL 763496, at *2 (Mich. Ct. App. Mar. 24, 2009) ("[F]act that the phones were marked up does not prove that plaintiffs purchased the phones in excess of the bona fide wholesale price"; "minimal" markup reflected shipping and general overhead expenses, including rent, insurance, handling charges and labor cost.).

93. *Atchley*, 2012 WL 6057130, at *4 (finding bona fide wholesale price exception applicable where per-pallet deduction from dealer's commission was "a fraction" of the cost to the supplier of packaging and delivering the pallets).

94. Coyne's & Co. v. Enesco, LLC, 2010 WL 3269977 (D. Minn. Aug. 16, 2010) (fifty percent markup may be insufficient to constitute a franchise fee where dealer "achieved a significant gross profit margin on its sale" of the products).

95. Comm'ns Maint., Inc. v. Motorola, Inc., 761 F.2d 1202 (7th Cir. 1985) (applying Indiana law) (no indirect franchise fee because subcontractor did not discount its price); Corp. Res., Inc. v. Eagle Hardware & Garden Inc., 62 P.3d 544, 547 (Wash. Ct. App. 2003) (subcontractor retained significant control over pricing).

96. Corp v. Atlantic-Richfield Co., 726 P.2d 66, 67–69 (Wash. Ct. App. 1986).

97. *Id.* at 69.

98. To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift Am., Inc., 152 F.3d 658, 663 (7th Cir. 1998) (applying Illinois law).

no evidence of an established market in the supplier's manuals, the court held that the exception did not apply.[99]

In the pretrial stages, courts have accepted a wide range of evidence of what constitutes a bona fide wholesale price in any particular case. This has included uncontroverted testimony[100] and a comparison to local retail prices[101] or the supplier's own posted prices.[102]

c. *Fact-Specific Inquiry*

The determination of whether or not a price is consistent with the bona fide wholesale price is necessarily a fact-specific inquiry.[103] Thus, at the pleadings stage, when courts are required to accept the allegations in the complaint as true, courts rarely characterize a price as a bona fide wholesale price.[104] A small number of courts have found defects in the pleadings sufficient to justify dismissal, but this is the exception rather than the rule. In *DuPage Fork Lift Service, Inc. v. Machinery Distribution, Inc.*, a federal district court dismissed a claim that the supplier's manipulation of certain discounts and rebates on the sale of equipment to the dealer constituted an indirect franchise fee. The court explained that "the mere revocation of a discount or rebate cannot constitute payment of an indirect franchise fee," absent

99. *Id.*

100. *See* PW Stoelting, LLC v. Levine, 2018 WL 6603874, at *5 (E.D. Wis. Dec. 17, 2018) (relying on affidavit of supplier's manager that prices charged—equipment at forty-five percent of list price and parts at fifty percent of list price—are consistent with the wholesale pricing system in the industry; dealer disputed assertion but provided no evidence); Kenaya Wireless, Inc. v. SSMJ, LLC, 2009 WL 763496, at *2 (Mich. Ct. App. Mar. 24, 2009) (dealer offered no evidence to refute supplier's affidavit); Hamade v. Sunoco, Inc., 721 N.W.2d 233, 243 (Mich. Ct. App. 2006) (supplier's affidavits explaining how wholesale price was calculated were not countered by admissible evidence).

101. Blanton v. Mobil Oil Corp., 721 F.2d 1207, 1211 (9th Cir. 1983) (applying Washington law) (price charged to dealer is an indirect franchise fee where it exceeds the retail price charged by local vendors).

102. *See* Lofgren v. AirTrona Canada, 2016 WL 25977, at *8 (E.D. Mich. Jan. 4, 2016) (indirect franchise fee found where dealer paid more than the price of the goods he received, based on supplier's own prices), *aff'd*, 677 F. App'x 1002 (6th Cir. 2017); Nature's Plus Nordic A/S v. Natural Organics, Inc., 980 F. Supp. 2d 400, 416 (E.D.N.Y. 2013) (where supplier gave dealer seventeen point five percent discount on its posted wholesale price, a requirement that dealer spend five percent of its purchases on advertising only reduced the discount and was not a franchise fee).

103. Louis DeGidio, Inc. v. Indus. Combustion, LLC, 2019 WL 6894437, at *4 (D. Minn. Dec. 18, 2019); Money Mailer, LLC v. Brewer, 449 P.3d 258, 262–63 (Wash. 2019).

104. Live Cryo, LLC v. CryoUSA Import & Sales, LLC, 2017 WL 4098853 at *6 (E.D. Mich. Sept. 15, 2017) (indirect franchise fee alleged in form of markup on sale of cryotherapy chambers); BP West Coast Prods., LLC v. Shalabi, 2012 WL 441155, at *5 (W.D. Wash. Feb. 10, 2012) (alleged greater-than-wholesale price due to zone pricing scheme and faulty deliveries); Bucciarelli v. Nationwide Mut. Ins. Co., 662 F. Supp. 2d 809, 820 (E.D. Mich. 2009) (alleged indirect franchise fee in form of overpriced office furniture); US Mac Corp. v. Amoco Oil Co., Bus. Franchise Guide (CCH) ¶ 11,963 (Cal. Ct. App. Aug. 16, 2000) (alleged fee of thirty-seven cents per gallon, as well as supplier's right to charge extra delivery fees, could be hidden franchise fees).

an allegation that the price paid before any discounts or rebates exceeded a bona fide wholesale price.[105]

As a general rule, a fact-specific inquiry is not good news for a business seeking a safe harbor within which to price goods or other items it sells to distributors, as it potentially means lengthy and expensive legal proceedings, including discovery and expert testimony, before a definitive answer is reached. Manufacturers and licensors that seek to avoid a claim that an indirect franchise fee has been embedded into an above-market price are well advised to research (and keep records of) relevant market prices on a regular basis and ensure that the goods and other items sold to dealers are in line with market prices.

III. Conclusion

Complying with the franchise laws can be an expensive endeavor. For those businesses that choose to operate as non-franchised distribution systems, the ability to predict whether a given expense will be deemed a "franchise fee" is critical. The alternative is often regulation by surprise, which is neither equitable nor sustainable.

A few conclusions can be drawn from the current state of the law respecting indirect or hidden franchise fees. With the important caveat that certain states' laws will affect the outcome, a distribution business wishing to minimize the risk of being deemed to be an inadvertent franchise should consider the following:

- Characterizations of an expense can be relevant. If a distributor is required to make a payment to a supplier, be sure that both parties agree, in writing, on what the payment is for. Consider reciting, in terms as specific as possible, the value that is being received in exchange for the payment. If a payment is for something other than the right to do business, designate that purpose in writing.
- When a distributor purchases goods for resale, ensure that the price is at or below market price for a similar level of distribution. On a regular basis, ascertain (and keep records of) concurrent prices for similar goods by other sellers in the marketplace. This advice applies equally to other items that are excluded from the definition of "franchise fees" by certain state laws if they are priced at "fair market value" or "economic value," such as equipment, fixtures and supplies; real property; loans to a franchisee; and promotional supplies.
- Make training fees and advertising expenditures optional, if possible. If a supplier believes that such expenses are worthwhile to promote the brand and increase sales, consider offering incentives for participation, rather than imposing fixed requirements.

105. DuPage Fork Lift Serv., Inc. v. Machinery Distrib., Inc., 1995 WL 125774, at *5–6 (N.D. Ill. Mar. 15, 1995).

While the past four decades have seen extensive development in the understanding and application of the franchise fee requirement, there remains a good deal of room for additional development. Those interpretations and decisions that adhere most closely to the policy goals underlying the franchise fee requirement, and that consistently apply market-based principles in their analyses, best advance the salutary objective of establishing—to the extent possible—a clearer roadmap toward more efficient and rational decision-making.