GARY W. LEYDIG

ADVOCATE · COUNSELOR · TRIAL LAWYER

Franchise Laws: How They Can Protect You As A Dealer*

Gary W. Leydig

Whether you know it or not, your distributorship may be a franchise and you may be protected from arbitrary termination by your principal manufacturer. If your current distributorship agreement is like most such documents, your manufacturer has guaranteed itself the absolute right to terminate your distributorship with little or no warning and for little or no reason. Needless to say, such an arrangement can lead to some anxious days and sleepless nights. Regardless of how solid you perceive your relationship with the manufacturer to be, the continued existence of your distributorship is precarious. Changes in personnel in your manufacturer's upper management or changes in its marketing plans (say, a desire to shift from smaller, local dealers to large regional distributors) could bring even a seemingly healthy and profitable relationship to an untimely end.

Historically, there was very little a distributor could do to protect itself when faced with termination. Both lawyers and the courts looked to contract law for guidance. That law, in short, states that contracting parties are free to reach whatever terms they deem between them to be fair at the time they enter into their contract. The courts steadfastly refused to rewrite a contract after the fact and undo the folly into which one party may have gotten itself. Unquestionably, such an approach could lead to extremely inequitable (though lawful) results. Years of heavy investment in the manufacturer's products, costly training of sales and service personnel in a particular product line, construction of specific facilities to satisfy the manufacturer's marketing goals and the development of a valuable customer list could, literally, be rendered valueless overnight with the receipt of a notice of termination. To overcome these inequitable results, lawyers representing a wide range of distributors have begun to look outside the confines of contract law and have found a welcome ally in state franchise laws. Of particular interest to the readership of this publication is a recent decision by the United States Court of Appeals for the Seventh Circuit which applied the Illinois Franchise

---

* This article originally appeared in *Material Handling Wholesaler* – Published November, 1998. Gary Leydig is *of Counsel* to the law firm of Riordan Fulkerson Hupert & Coleman in Chicago, Illinois. His biography and practice description can be found at LeydigLaw.com .

Disclosure Act to a forklift dealer and affirmed a sizable verdict for that dealer who was terminated as part of the manufacturer's changed marketing strategy. That case, *To-Am Equipment Company, Inc. v. Mitsubishi Caterpillar Forklift America, Inc.*, should result in a better night's rest for distributors, and forklift dealers in particular.

You don't have to sell hamburgers to be a franchise

Approximately one-half of the states have enacted laws for the protection of franchises. No two of the statutes are exactly alike and, often, even what appear to be minor and benign differences can have a dramatic effect on how the statutes will be interpreted by courts. It is well beyond the scope of this article to provide a survey of each state's franchise act and the differences between them. It cannot be stressed enough, therefore, that you and your attorney must first look to the particular act in your state and make an independent evaluation of whether it covers your business. The Illinois Act which was applied by the court of appeals in the *To-Am* decision is a useful starting point, however. It was crafted to closely follow the Uniform Franchise and Business Opportunities Act, which is a model act on the subject. Odds are if your state has a franchise act it too will have borrowed heavily from this uniform act and will have many or all of the features which came into play in *To-Am*.

A common theme of the various franchise laws is to level the playing field between the franchisor (generally perceived as having superior economic power and therefore superior negotiating leverage) and the franchisee. This leveling is achieved in two ways. First, the franchise laws typically require the franchisor to register with the state (often the state attorney general) and further require the franchisor to provide prospective franchisees with a prospectus or some form of disclosure document. The disclosure document ideally gives the franchisee sufficient information to make an intelligent decision whether or not this is a business he should be getting into. With regard to the franchisor's obligations to register and provide a disclosure statement, a franchisor must strictly comply with these requirements. No matter how knowledgeable the prospective franchisee is of the industry, if the franchisor fails to register with the state or provide the distributor with the requisite prospectus prior to entering into a franchise agreement, the new franchisee will generally have the absolute right to rescind the agreement. This could come in handy if you have second thoughts about those twenty lift trucks the manufacturer insisted you order for your floor at the time you signed up as its new distributor. As you might expect, this extreme right of recision is usually a very short lived right, and must be exercised by the franchisee within ninety days or some other limited period following execution of the distributor/franchise agreement. If you do not timely exercise your right to rescind, it is lost for good.

The second way in which franchise laws level the playing field between franchisor and franchisee is to imbue the franchisee with certain rights that cannot be revoked by the franchisor - sort of a franchisee's bill of rights. Even if you sign a contract which purports to give the right up, the courts will not enforce the contract and will allow you to exercise your rights under the franchise laws. The most important of these rights – and the one that was the focus of the *To-Am* case – is <u>the right not to be terminated prior to the term of the agreement except for good cause</u>. This right exists even if the franchise agreement expressly states that the manufacturer has the right to terminate at any time for any reason. A franchisee who is terminated without good cause and in violation of the statute has the right to recover all damages caused by the termination, together with attorneys' fees and litigation expenses. This is a substantial right and one that should put the franchisee in an equal negotiating position when faced with the threat of termination.

Perhaps we're getting ahead of ourselves, though. All of these rights under the franchise acts are wonderful if you are a franchisee. But how in the world can a forklift distributor (or parts distributor, or racking distributor, or any other type of distributor) be considered a franchisee? You've never thought of yourself as operating a franchise. Your manufacturer has never said you are a franchise. You don't sell fast food or run a convenience store. Your distributor agreement does not identify itself as a franchise agreement. Indeed, it may even contain language that says it is not a franchise agreement. The fact of the matter is, a franchise is what the statute says it is – whether the parties to the arrangement ever thought about it or not. In short, if it walks and quacks like a duck, it is duck. If you meet the definition of a franchise, you are a franchise. The manufacturers of course will cry foul (no pun intended) and argue that such an approach is overly simplistic and causes distributors to be covered by franchise acts when they were never intended to be covered. First, though simple, the approach is not simplistic. With every statute that seeks to create a class of individuals or businesses that are entitled to special protection, you must first define that class. Once defined, you are either within the definition or not. The courts cannot (or should not) attempt to divine what they think the law should be or what the legislature meant other than to look at the specific words used by the legislature. The appellate court in *To-Am* said it well: "While we understand [the manufacturer's] concern that dealerships in Illinois are too easily categorized as statutory franchisees, that is a concern appropriately raised to… the Illinois Legislature…, not to this court." Second, it is this author's opinion that a forklift distributor is precisely the type of business the legislatures intended to protect when the acts were passed into law. The franchise laws are clearly intended to protect owner-operated businesses who have invested in and "bought into" a particular provider's services or products. Under the franchise laws, the investor-businessman who sinks his resources into a specific, trademarked product line (whether it be hamburgers, mufflers or forklift trucks) should not have that business arbitrarily or prematurely yanked away from him. That is the law and you should not be shy on insisting in the enforcement of your rights if in fact you are a franchise.

What is a franchise? The uniform act and the Illinois act define it the same basic way and require three specific criteria be met. First, the operation of your business must be "substantially associated with the franchisor's [read: "manufacturer's"] trademark, service mark, trade name, logo-type, advertising or other commercial symbol." Second, you must be "granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan prescribed or suggested in substantial part by the franchisor." And third, you must be "required to pay, directly or indirectly, a franchise fee of $500 or more." If you meet this definition, you are a franchise.

The first criteria will generally be easily met by the distributor. You are the manufacturer's chosen distributor; both you and the manufacturer will have gone to great lengths to ensure that your distributorship is linked in the buying public's mind with the manufacturer and its trade names and trademarks. Odds are the sign on your door bears the trademark, as do your letterhead, business cards and service trucks. You advertise in the yellow pages, at trade shows and elsewhere with the trademark –

typically with line art and graphics supplied by the manufacturer,. In short, you are "substantially associated with" the manufacturer's trademark.

The second criteria may be a little more problematic but in most instances can be met. A "marketing plan" is defined as some plan or advice by the manufacturer on how the distributor should conduct its business. The first thing to keep in mind is that the marketing plan (at least in the law applied in *To-Am*) only has to be suggested; the suggestions do not necessarily need to be followed. The types of suggestions as to how a distributor should operate its business and which will give rise to a "marketing plan" include: price specifications; special pricing systems or discount plans; use of particular sales or display equipment or merchandising devices; use of specific sales techniques; use of advertising or promotional materials; cooperation in advertising efforts; site selection; territory exclusivity; training programs; limitations on products or services that can be sold; customer relations advice; and warranty advice. It will probably be the rare manufacturer – distributor relationship where many of these types of items are not both suggested and followed. Often the conduct is mandated by the manufacturer, such as participation in pricing plans, advertising programs, warranty programs, and attendance at a certain number of training sessions for both service and sales personnel.

The third criteria, payment of a franchise fee, will usually be the sticking point and will require a creative analysis of your operations by you and your lawyer. (Look at your particular statute closely. This is one area where individual states have made the greatest variance from the norm. The changes can be critical). Almost certainly, you never directly paid your manufacturer a specific start-up or signing fee for the right to be a distributor. Do not fear. A direct fee is not required and will rarely be found. The legislators who drafted the franchise laws knew perfectly well that if potential franchisors could avoid compliance with the franchise laws by simply hiding or burying their fees, they would. Precisely for that reason the franchise laws have defined "franchise fee" very broadly and give the same effect to an indirect fee as to a direct one. In Illinois and the uniform act for example, a fee is "any fee or charge that a franchisee is required to pay directly or indirectly for the right to enter into [the franchise], including, but not limited to any such payments for goods or services…" Expressly excepted from this broad definition are purchases of goods for which there is an established market at a bona fide retail or wholesale price. For example, your purchase of a truck for resale at a bona fide wholesale or retail price is excepted from the definition of a fee. In Illinois and other states, the governmental body directed to enforce the act can and have elaborated on the definition of a franchise fee. The Illinois attorney general for example has promulgated regulations which make clear the intent of the statute to apply the term "franchise fee" liberally. Under these regulations, a fee can exist "regardless of the designation given to or the form of the fee, whether payable in lump sum or installments, definite or indefinite in amount, or partly or wholly contingent on future sales, profits or purchases of the franchise business."

Needless to say, these definitions are extremely broad and will engulf payments you may never have considered as fees. In determining whether you fall within the protection of the franchise act, first identify every payment you have made directly to the manufacturer over the entire life of your distributorship. Then, ask yourself these questions: Was the payment <u>required</u>? If it was voluntary or discretionary, it probably will not qualify as a fee. Was the payment <u>to</u> the manufacturer? If you had to send your service staff to a training center for required training programs, the payments you made for airline tickets, hotel rooms and food tabs are not to the manufacturer and will not be considered a fee. The manufacturer's registration fee, however, probably is. If your payment to the manufacturer is for the purchase of a product, is there a market to resell that product, or is it a product that you are stuck with and which cannot be resold in any recognized market? If the former, there is no fee. If the latter, there is probably a fee. If you are required to purchase a particular product that cannot be resold (for example, a store sign), that the manufacturer does not require you to purchase from them, but allows you to purchase the same product from other vendors, then you probably do not have a fee. Be creative and thorough. Look at all payments you have made. A classic example of a hidden, indirect franchise fee is the manufacturer's insistence that you purchase excessive or unusual inventory that cannot be reasonably sold by you or which cannot be sold over any reasonable period of time. The courts are very quick to find an indirect fee under those circumstances. In *To-Am*, the distributorship agreement required the distributor to "maintain an adequate supply" of service manuals. Testimony revealed that the one free set of service manuals provided the distributor was not adequate; that multiple sets were required for the service department, parts department, service vans and to replace manuals as they wore out or were lost. These extra manuals were therefore required to be purchased by the distributor, were not purchased for resale, and could only be purchased from the manufacturer. Voila! An indirect franchise fee.

If you meet the definition of a franchise, you can only be terminated for "good cause." This does not mean you are termination-proof. If you are in breach of some material aspect of your contract and you fail to cure that breach within a reasonable time after the manufacturer has put you on notice of the breach, you can be lawfully terminated. In other words, an uncured breach of contact is "good cause" for termination. "Good cause" is also defined in the act to include your "repeated" failures to comply with the lawful provisions of the contract, an assignment of your assets for the benefit of creditors, abandonment of the business or conviction of a felony or some other crime which impairs the good will of the manufacturer's trademark. Any of these latter instances of "good cause" can result in immediate termination, without any right to cure the problem first. What is particularly important about these definitions of "good cause" is that they all require some form of misconduct by you the distributor. "Good cause" does <u>not</u> include the manufacturer's changed marketing plan or its profit-driven decision to change distributors. The manufacturer may have perfectly understandable and justifiable economic and marketing reasons to terminate the distributorship. However, unless the basis for termination is a breach of the contract by you, those economic and marketing reasons are not "good cause".

Stand your ground in the face of a termination notice

If you are a franchise and you are threatened with an improper termination prior to the term of your agreement, you no longer need to raise the white flag and give up if you are fortunate enough to live in those states with favorable franchise acts. What the manufacturer is doing is plainly and simply against the law. It is up to you to assert your rights. One of the first things you may want to do is hand your manufacturer's representative a copy of the *To-Am* decision and politely suggest that the manufacturer change its mind about the termination. This alone may have a sobering effect on the manufacturer. It may be though, that in light of the manufacturer's expressed desire to give you the ax a continuing relationship, even if you are entitled to insist upon it, will not be in your best interest. Whatever level of trust existed before the attempted termination will probably evaporate and it may become extremely difficult to go forward as effective business "partners." An alternative may be to negotiate a buy-out of your business by the manufacturer. The manufacturer may well be open to such a suggestion. At that point in time its options may be relatively limited. If your analysis of the applicable franchise law is right, the manufacturer should withdraw the termination. More than likely, however, the manufacturer has already lined up and made commitments to the new distributor who was suppose to replace you. The manufacturer may find itself stuck between a wrongful termination suit by you if it goes forward with the termination, and a breach of contract action from the "new" distributor if it does not go forward with the termination. Even if a new distributor has not been lined up, you may simply no longer fit into the manufacturer's master plan. A negotiated buy-out of your business may prove to be in everyone's best interest.

If the manufacturer insists on proceeding with the termination and also refuses to acknowledge that its actions are unlawful, you may have no option but to proceed with litigation. If you are forced down that path, don't delay. Among other things, you and your attorney may want to seriously consider bringing an immediate action seeking a temporary restraining order and preliminary injunction to stop the termination before it becomes effective. If you are going to lock legal horns with the manufacturer, you are going to need cash flows to maintain the legal team you have retained, not to mention satisfying your banks and vendors. A terminated, non-operating dealership does not generate cash flow and the manufacturer could ultimately win the case by sheer attrition. So do what you have to to keep your doors open and the cash flowing. If you are reading this article too late for such action or for some other reason injunctive relief is not viable or advisable, the franchise laws still require prompt action by you to enforce your rights. Applicable statutes of limitation (the time within which a lawsuit must be filed) can be very short – one year or less. Once you are engaged in litigation with the manufacturer, be prepared for the long, often frustrating process that is our legal system. But whatever you do, don't lose heart. This system may be frustrating but in the end it is a system that usually works. And if you think David can only stand up to Goliath in children's stories, just take a look at how little To-Am Equipment Company fared against the giant Mitsubishi Caterpillar Forklift America.