The Terrifying New York Definition of a Franchise

By Thomas M. Pitegoff

Licensing is big business. Brand owners may license selected product lines, create brand extensions, enter new markets, or simply enhance their brands through licensing. But few brand owners know that the New York Franchise Sales Act (NYFSA), by its terms, regulates licensors who provide no marketing assistance and impose no requirements other than quality control.

The definition of a "franchise" under the NYFSA is extremely broad.[1] It covers far more business arrangements than anyone would reasonably consider to be a franchise. This anomaly puts New York franchise law in "left field," as the late Rupert Barkoff noted in his excellent article published in the *New York Law Journal* on May 1, 2012.[2] This is an understatement. The NYFSA, which has not been revised since it went into effect in 1981, is not even in the same ballpark as similar legislation in other jurisdictions. Barkoff called this anomalous New York definition of a franchise "terrifying."

In order to sell franchises anywhere in the U.S., a franchisor must prepare a detailed franchise disclosure document that includes audited financial statements. A franchisor located in New York, or a franchisor that intends to sell franchises to buyers in New York, must register the offering with the state Attorney General's Office before the franchisor may lawfully sell franchises from or in the state. The franchisor must then make the required disclosures to each prospective franchisee and wait 10 business days (or 14 calendar days in the other dozen or so states that regulate franchise sales) before entering into the agreement or accepting any payment.

Failure to comply with the NYFSA can result in enforcement action by the New York State Attorney General's Office and private actions by franchisees for rescission, damages, injunctive or declaratory relief, attorneys' fees, and costs. Willful violation of the NYFSA can lead to punitive damages and criminal liability.

Not only can a simple trademark license agreement be a franchise in New York. A marketing consulting agreement can also be a franchise. So can a distribution arrangement where the distributor must pay an initial fee to the supplier to gain the right to distribute in a specific market or territory. To put this another way, outside of the business arrangement that we all know as a franchise is a large "gray" area in which the arrangement is at risk of being a franchise under New York law.

In short, the NYFSA is a trap for the unwary. Most people would not think of consulting with a franchise lawyer before entering into a trademark license agreement or a marketing agreement. Yet failure to comply with the NYFSA can give ammunition to an aggrieved licensee in a dispute with its licensor or result in prosecution of the licensor by the New York State Attorney General's office.

The broad definition of a franchise cries out for change in the law.

A Two-Prong Definition Impedes Business in New York

The definition of a franchise under most franchise sales laws contains three elements: a fee, a trademark and a marketing plan prescribed in substantial part by the franchisor. The franchise sales laws of Maryland and Virginia are typical examples.[3] These definitions, unlike the New York definition, are also similar to the definition of a franchise under the Federal Trade Commission's trade regulation rule on franchising (the "FTC Rule"), which also contains three elements.[4]

The New York definition of a franchise has just two elements.[5] One element is either a trademark or a marketing plan prescribed in substantial part by the franchisor. The second element is a fee.

Each of the franchise sales laws, of course, has various exemptions and exclusions from the definition of a franchise.[6]

Both prongs of the NYFSA's definition of a franchise raise issues. Starting with the first prong, what does it mean to grant "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 a franchisor" without a trademark? A marketing consultant may provide a marketing plan to a client to enable that client to launch a business. Certainly, the client will pay a fee. Is this a franchise? When does such an arrangement constitute a "grant" of the "right" to engage in a business? The statute is not at all clear on what type of arrangement this prong of the definition is intended to cover.

The second prong is easier to understand but is extremely broad. The plain language of the statute covers many license and distribution arrangements that would not be considered franchises in other states. Any trademark license granting someone a right to engage in a business in consideration for a royalty would fall within the definition of a franchise under the NYFSA. So would a distribution arrangement with no grant of trademark

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rights in which the distributor pays a one-time fee to the supplier to purchase the distribution rights. These are not the types of business arrangements that anyone unfamiliar with New York law would expect to be franchises.

For licensors who receive proper legal advice, this broad definition is an impediment to doing business in the state of New York or with a person located in New York. The proper advice in many of these cases is that the broad scope of the New York law creates risk and imposes a degree of uncertainty. This advice would discourage some from locating their business in the state. Why would a licensor choose to be subject to the extensive franchise registration and disclosure requirements in New York when the company can avoid these requirements by locating in or licensing into any other state? Why would a consultant based in New York or working with a New York client provide a marketing plan to enable the client to launch a busines?

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For Traditional Franchisors, New York's Broad Definition of a Franchise Is a Non-Issue

Companies that offer traditional franchises have no issue with the broad definition of a franchise under the NYFSA. Franchisors know that they must prepare franchise disclosure documents in accordance with the FTC Rule and, when necessary, also in accordance with the requirements of the NYFSA and the franchise laws of other states. Franchisors register their franchise offerings in New York as they do in other states and they make the required disclosures to prospective franchisees.

The broad definition of a franchise under the NYFSA also does not adversely affect franchisees or prospective franchisees in traditional franchise arrangements. They receive the required disclosures from their franchisors regardless of the law's overly broad definition of a franchise.

The "terrifying" aspects of the New York definition apply only to those who would not be considered franchisors under the FTC Rule or the franchise sales laws of any other state.

Narrowing New York's broad definition of a "franchise" to conform to the definition in other states would have no effect on franchisors or franchisees as those terms are commonly understood.

Does the Broad Definition Serve a Useful Purpose?

In practice, relatively few litigants raise the issue of noncompliance with the NYFSA against trademark licensors or marketing consultants. The Attorney General's Office seldom prosecutes business arrangements that are not commonly understood to be franchises. The reason may be that these business arrangements do not require the protections that the NYFSA affords to prospective franchisees.

Maybe we should view trademark licensors and certain marketing consultants in New York as we do drivers who speed on a highway. Drivers often speed. Only a small number are prosecuted. But speeding is dangerous. A simple trademark license agreement or marketing consulting agreement is not.

The sparse enforcement of the NYFSA does not change the fact that the threat is always there. An enforcer can arbitrarily decide at any time to enforce it. Why should a licensor or consultant have to run this risk?

The fact that the Attorney General's Office does not apply the law to arrangements that are not commonly understood to be franchises also indicates that the Attorney General's Office may not view the broad definition as a necessity. Cutting back the definition so that it conforms to the laws of other states would not significantly change the enforcement activity at the Attorney General's Office. Nor would it change the way private litigants behave.

A revised NYFSA could eliminate the registration and disclosure requirement for businesses that lie in the "gray" area of the New York definition today while retaining the Attorney General's broad anti-fraud jurisdiction for these businesses. If necessary, the state might even consider enacting a "business opportunity" law, as roughly half of the states have done, which would regulate some business arrangements in the "gray" area but have far less onerous registration and disclosure requirements than a franchise law.

The broad definition of a franchise has been a part of the NYFSA since it became effective in 1981. New York was the last state to enact a franchise sales law, and that law has never been amended.

One commentator noted in 2012 that the NYFSA "was crafted to attack a vast criminal invasion of the franchise arena which transpired in the 1960s and 70s (including significant organized crime involvement) and to safeguard New York's reputation as the financial capital of the world."[7] In other words, the NYFSA was written expansively in order to give the Attorney General broad latitude to prosecute bad actors who might run off with initial franchise investments of would-be franchise buyers. The same author noted in 2020 that on its 40th anniversary, the NYFSA "achieved its intended purpose—

the eradication of massive fraud and criminality that had permeated the then-nascent franchise arena."[8]

Even if there was a need for a franchise law with such broad application in 1981, there is no such need today. Undoubtedly, the FTC Rule, which went into effect in 1979, also played an important role in cleaning up an industry that was riddled with fraud, as did the franchise laws of other states, which were all enacted in the 1970s before the FTC Rule became effective.

Time for Change

Most business owners want to comply with applicable laws. If by chance or good fortune a business owner based in New York or planning to do business in New York happens to consult with a franchise lawyer before entering into a trademark license agreement or a market consulting agreement, that business owner might be advised either to seek a discretionary exemption or to locate the business outside the state of New York and to consider not entering into the contract with anyone who is located in New York. This sounds extreme because it is.

Franchising is a respected way of doing business. Franchising is also an important part of the U.S. economy.[9] With some careful revising, the NYFSA can make franchising a far more important part of the New York economy than it is today. The broad definition of a franchise under the NYFSA today is the single most important reason to change this law. It is high time for New York State to change its definition of a "franchise" to conform more closely with the franchise sales laws of other states.

Endnotes

1. N.Y. General Business Law (GBL) Article 33, Section 681.3 defines a franchise as follows:

   > "Franchise" means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:
   >
   > (a) A franchisee 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 a franchisor, and the franchisee is required to pay, directly or indirectly, a franchise fee, or
   >
   > (b) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate, and the franchisee is required to pay, directly or indirectly, a franchise fee.

2. Rupert M. Barkoff, *New York Franchise Act: Out in Left Field*, NYLJ 5/1/2012.
3. Section 14-201(e)(1) of the Maryland Business Regulation Code provides as follows:

   "Franchise" means an expressed or implied, oral or written agreement in which:

   (i) 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;

   (ii) the operation of the business under the marketing plan or system is associated substantially with the trademark, service mark, trade name, logotype, advertising, or other commercial symbol that designates the franchisor or its affiliate; and

   (iii) the purchaser must pay, directly or indirectly, a franchise fee.
4. Section 13.1-559(A) of the Code of Virginia (the Retail Franchising Act) defines a "franchise" as follows:

   > "Franchise" means a written contract or agreement between two or more persons, by which:
   >
   > 1. A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services at retail under a marketing plan or system prescribed in substantial part by a franchisor;
   >
   > 2. The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and
   >
   > 3. The franchisee is required to pay, directly or indirectly, a franchise fee of $500 or more.
   >
   > 16 CFR Section 436.1(h) provides as follows:
   >
   > Franchise means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:
   >
   > (1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;
   >
   > (2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and
   >
   > (3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.

5. *Supra* note 1.
6. *See* Leslie D. Curran and Beata Krakus, eds. *Exemptions and Exclusions Under Federal and State Franchise Registration and Disclosure Laws* (ABA Forum on Franchising, 2017).
7. David Kaufman, *In Defense of the New York Franchise Act*, N.Y.L.J. June 26, 2012.
8. David Kaufman, *New York Franchise Act Turns 40—A Look Back*, N.Y.L.J. June 25, 2020.
9. *See, e.g.,* https://www.franchise.org/franchise-information/franchise-business-outlook/franchise-business-economic-outlook-2020.

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