



Lessons Learned

A continuing column drawing lessons for franchise systems from franchise litigation and other sources.

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No Liability for Sale of Unregistered Franchises

Normally, a Franchisor's sale of an unregistered franchise would result in something close to a "slam dunk" judgment in favor of a Franchisee suing under a state franchise law. After all, proving that the Franchisee bought the franchise, and that the Franchisor was not registered at the time, should normally be a relatively simple process for the Franchisee's attorney, assuming that the actual facts support the claim.

However, as a recent California case (FF Orthotics v. Joe Paul) demonstrates, things are not always that simple, and in this case the Franchisor was able to avoid liability due to a close reading of some of the provisions of the California Franchise Investment Law (the "CFIL.")

The facts in the case showed that the defendant company was advised by its attorney to not register as a Franchisor (supposedly, so as to avoid disclosure of a felony conviction involving the founder) and that the company should expand its business by using a "dealership agreement" rather than a franchise agreement, advice which is, at the very least, questionable in light of the court's opinion, as shown below.

Following the attorney's advice, the defendant company awarded "dealerships" to several California-based individuals and companies, as well as to persons and companies in other states. Perhaps not surprisingly, some of the "dealers" ultimately sued, claiming that the relationship was, in fact, a franchise and that the defendant had violated the CFIL by selling an unregistered franchise.

By the time the case reached the appellate court, the defendants conceded that the dealership agreements were franchise agreements that should have

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been, and were not, registered under the CFIL, contrary to the opinion of the companies attorney. In most cases, this would have been fatal to the defendant's hopes to avoid liability to the Franchisees, but two provisions in the CFIL operated to save the Franchisor.

First of all, the suing Franchisees located in California bought their franchises more than four years before they filed suit and the relevant portion of the CFIL imposes a four year statute of limitations on violations, including those of the registration requirements. Therefore, since the Franchisees had not filed suit within that time period, they were barred from obtaining any recovery.

Second, as to Franchisees located in Alabama and North Carolina, while they may have filed their lawsuit within the proper time, a specific section of the CFIL (Section 31105, originally drafted by Holmes & Lofstrom attorneys, and passed into law with their participation) exempts from the CFIL's registration requirement offers and sales to out-of-state residents, where the franchised business is also physically located outside California. The court found that that was true as to the Alabama and North Carolina Franchisees and their business, and denied recovery to them.

Here the Franchisor was lucky, and three lessons emerge: (1) In structuring any distribution system which might be a franchise, obtain (and follow!) the advice of sophisticated, conservative and experienced franchise counsel; (2) when in doubt, register the offering; and (3) do not assume that an unregistered sale will automatically result in liability – it may, but a close review of the applicable rules may reveal an “escape hatch” or two!

David Holmes has practiced domestic and international franchise law for more than 30 years. David earned his undergraduate and law degrees from the University of Southern California. He specializes in franchise law, including structuring franchise systems, drafting registration documents, legal compliance, litigation management and negotiations. He also serves as an expert witness on franchising matters in both federal and state courts and has taught graduate level business law courses at California State University, Long Beach. He contributes to the publications and committees of the International Franchise Association, American Bar Association and California State Bar.