franchise law journal

Volume 10, Number 2 Quarterly Journal of the Forum on Franchising Fall 1990

Franchise Advertising Funds: Structural, Tax, Operational, and Liability Issues

by Neal D. Borden, Andrew A. Caffey and Sharon C. Casey*

Neal D. Borden

Andrew A. Caffey

I. Introduction

Sharon C. Casey

One of the most important business advantages of franchising is the regional or national promotion of a single trade name or trademark by a network of contributing franchisees. This is typically accomplished through the vehicle of a pooled fund of franchisee contributions, usually called a national advertising fund. These shared advertising programs are playing an increasingly prominent role in the promotion of many different franchised businesses, but little specific attention has been paid to them. As larger franchise systems have developed, the size of the national advertising funds has grown substantially, requiring more staff and producing a wider range of activities. Such funds not only raise many legal issues, but also challenge franchisor executives with business and system ramifications unique to franchising.

A host of issues are posed—the collection and organization of pooled advertising funds, the structure of a system-wide fund, governance (formal and practical), franchisor control, franchisee participation, tax treatment, and operational matters. An informal survey of franchisors conducted by the authors confirmed that franchise advertising programs have taken several different forms in the franchisor community, and they are governed and operated in a variety of ways.

Franchisor executives are often unaware of the implications of their decisions regarding advertising funds. This article reviews the legal and tax issues raised by these funds, highlighting the sparse case law about them and noting pertinent business solutions where they have been observed.

(*continued on page 33*)

*Messrs. Borden and Caffey are partners in, and Ms. Casey is of counsel to, the Washington, D.C., office of Venable, Baetjer, Howard & Civiletti.

Elsewhere in This Issue

test: So long as there was a connection between the cause of action and the defendants' contacts with the jurisdiction, due process was satisfied even if the purposefulness of the action was not specifically and deliberately directed at the foreign jurisdiction and even if the defendant did not enjoy any individual benefit. It was enough if the defendant acted with the knowledge that its actions would have injurious *effects* in the foreign jurisdiction.

To be sure, *Calder*'s holding rested largely upon the uncontested first element—California substantive law provided that an individual employee who actively participated in making a libelous statement could be held individually responsible for injuries incurred as a result of the libel. Had California substantive law immunized the employee, however, (as it might in the case of the hypothetical welder) then the first element would be missing and the effects tests might never have been reached. Indeed, some courts have noted that *Calder* might be limited to libel cases. *See, e.g., Shapiro v. Sun Life Assurance Co. of Canada*, 117 F.R.D. 550 (D. N.J. 1987).

Since *Calder* was handed down, courts appear to have embraced the "effects" test enthusiastically, and have hailed employees into court in employment cases, *Donovan v. Grim Hotel Co.*, 747 F.2d 966 (5th Cir. 1984); *Brainerd v. Governors of the University of Alberta*, 873 F.2d 1257 (9th Cir. 1989); *Byer v. Gordos Arkansas, Inc.*, 712 F. Supp. 149 (W.D. Ark. 1989); *Kula v. J.K. Schoefield & Co., Inc.*, 668 F. Supp. 1126 (N.D. Ill. 1987); in insurance agreement cases, *Shapiro v. Sun Life Assurance Co. of Canada*, 117 F.R.D. 550 (D. N.J. 1987); antitrust cases, *Williams Electric Co., Inc. v. Honeywell, Inc.*, 847 F.2d 741 (11th Cir. 1988); investment fraud cases, *Davis v. Metro Productions, Inc.*, 885 F.2d 515 (9th Cir. 1989); and in franchise fraud cases, *Stuart v. Federal Energy Systems, Inc.*, 596 F. Supp. 458 (D. Vt. 1984). Indeed, New York's highest court, citing *Calder*, backpedaled in a recent decision and took the position that New York had never adopted the fiduciary shield doctrine, despite lower court and federal decisions to the contrary. *Kreutter v. McFadden Oil Corp.*, 71 N.Y.2d 460, 522 N.E.2d 40, 527 N.Y.S.2d 195 (Ct. App. 1988).

So what does all of this have to do with franchising? Simply stated—where substantive law provides a basis for direct recovery against officers and directors, due process will not stand as a barrier to a franchisee's suit against the officers and directors of a franchisor in a foreign jurisdiction. Most registration and disclosure laws expressly provide for liability of officers and directors for violation of those laws. Common-law fraud doctrines frequently implicate officer and director liability if the officers and directors actively participate in the fraudulent acts. *See, e.g., Stuart v. Federal Energy Systems, Inc.*, 596 F. Supp. 458 (D. Vt. 1984). RICO claims against officers and directors are direct claims, as to which the fiduciary shield doctrine has never applied; *Calder* makes it clear that due process does not bar the assertion of such claims against officers and directors in a foreign jurisdiction.

A franchisee might thus constitutionally exercise jurisdiction over officers and directors if the "effects" test is satisfied. Franchise sales, because of the extent of federal and state regulation, are almost always going to be directed at specific states. Selling a franchise in North Dakota is vastly different from selling in New Jersey an automobile which has an accident in New Mexico injuring Florida residents.

What are the implications of *Calder*? First, franchise officers, directors, and employees cannot necessarily depend on their positions as "mere employees" to protect them from claims in foreign jurisdictions. Second, although the matter does not appear to have been litigated, a franchisee claim against officers, directors, or employees may not be subject to a mandatory choice of forum clause in the franchise agreement. While such clauses have enjoyed widespread acceptance by the courts in recent years, they are frequently binding only with respect to disputes between the franchisor and franchisee. A franchisee could conceivably claim that such a provision would not apply to a claim against an officer, director, or employee. Finally, it is clear that at least in some circumstances the fiduciary shield doctrine continues to have vitality, especially if, as a matter of substantive law, the employee is merely carrying out the policies of the employer. Thus, franchisor counsel might consider advising a franchisor to articulate a written company policy with respect to franchise sales and statements made in the offering circular so that repetition of such statements by officers or employees would be documented as consistent with company policy. *See, e.g., Shapiro, supra; Williams, supra.* Although it is not absolutely clear that the franchisor's employees will be immunized from liability on all conceivable counts of a complaint, it would provide a significant level of comfort.

franchise advertising funds

(*continued from page 1*)

II. Structural Alternatives

The authors' informal survey indicates that most franchisors do not establish a separate legal entity through which franchisee advertising fund activities are conducted. Many franchisors commingle fund contributions with their other receipts and account for the "advertising fund" through bookkeeping entries. Franchise agreements often provide, however, that the franchisees' contributions to the advertising fund must be segregated from the other funds of the franchisor, and generally these franchisors simply maintain a separate bank account which constitutes the "fund," rather

than establishing an independent legal entity such as a trust or nonprofit corporation.

Either commingling the advertising funds with other funds of the franchisor or merely using a separate bank account in the franchisor's name can expose the franchisor to several problems. Potentially most troublesome could be assessments of tax liability by federal and state tax authorities who view the advertising fund contributions as income to the franchisor and, therefore, subject to tax. Also, the franchisor may have greater potential liability for a variety of claims which could arise out of the fund's advertising and promotional activities.

Structuring the franchisee advertising fund as a separate legal entity can help safeguard the fund assets from attachment and seizure in the event of a judgment against the franchisor and also in the event of a reorganization/bankruptcy of the franchisor.

One alternative is the creation of a trust to collect the franchisees' advertising contributions and make disbursements. As a separate legal entity, the trust would sign advertising contracts in its own name and file its own tax return. A trust should also provide significant legal "insulation" for the franchisor with respect to liability arising from the trust's activities, although as discussed below, the franchisor would likely indemnify the trustees with respect to personal liability they might incur arising from their trustee activities.

A third alternative structure would be a nonstock, nonprofit corporation. Most states have a nonprofit corporation statute[1] which generally provides that a "not-for-profit" corporation is one in which no shares of stock may be issued (although it may have "members"), and no part of its income may be distributed to its members, directors, or officers other than reasonable compensation for services rendered and distribution upon final dissolution or liquidation. Under most of these statutes, a nonstock corporation need not have any members, in which case a board of directors (either elected or appointed as set forth in the corporation's bylaws) has complete control over the corporation.

Many states also have a statute regarding formation of a cooperative association, a different type of legal entity which is also deemed to be a not-for-profit enterprise.[2] A cooperative association must have "members" from whom the board of directors is chosen. The association's bylaws presumably would provide that every franchisee is automatically a member of the cooperative association, if the association will engage in national or networkwide advertising.

Structuring the franchisee advertising fund as a separate legal entity can help safeguard the fund assets from attachment and seizure in the event of a judgment against the franchisor and also in the event of a reorganization/bankruptcy of the franchisor. In addition, if an undercapitalized franchisor has cash flow problems, segregating fund contributions in a separate legal entity can discourage the franchisor from "borrowing" monies from the fund, thereby depleting amounts available for advertising and subjecting itself to franchisee claims for misuse of these funds.

Although the topic of regional and local franchisee advertising cooperatives is not within the scope of this article, franchise agreements often provide that the franchisee must join and contribute to a regional or local advertising cooperative if such a cooperative is established. This contract provision is obviously intended to prevent a "free ride" by those who would benefit from the advertising, whether or not they contributed to the cooperative. These cooperatives generally are established either under the franchisor's direction or by the local franchisees themselves. Some are incorporated as a nonprofit corporation or a cooperative association, and others are simply unincorporated associations.

III. Fund Governance

Where the advertising fund is a separate bookkeeping or bank account of the franchisor, the franchisor often retains complete control and discretion over the creative concepts, materials, media allocation and expenditures of the fund. The franchisor may establish a committee or board of franchisees, either appointed by the franchisor or elected by fellow franchisees (perhaps on a regional basis), to advise the franchisor with respect to advertising and promotional matters. Some advisory boards have both franchisees and employees of the franchisor as members.

The decisions of the advertising fund board as to the activities of the fund may be binding on the franchisor. In *The Advertising and Policy Committee of the Avis Rent A Car System v. Avis Rent A Car System, Inc.*,[3] the court enjoined the franchisor, Avis, from conducting any national advertising program without the prior approval of its advertising and policy committee made up of franchisor and franchisee representatives. The court held that the committee had the *exclusive* right to conduct the franchise system's national advertising program and that no other national advertising could be conducted. The franchisor was further enjoined from exercising its right to control the use of its trademarks and trade name arbitrarily, unreasonably, or for an improper purpose. Thus, even if a franchisor decides to yield complete control over the fund to the board, the relevant document setting forth the authority and powers of the board

should expressly reserve to the franchisor the right to conduct advertising and public relations activities at its own expense and in its sole discretion.

If the fund is organized as a trust, the franchisor must determine who the trustee or trustees will be. Appointing an independent, institutional trustee would provide the most legal distance between the franchisor and the fund, to protect against potential tax and other liabilities. There are, however, several drawbacks to designating an institutional trustee. It will probably be difficult to find a bank or other financial institution willing to assume such a role in light of the potential exposure to claims by franchisees and third parties such as advertising agencies and customers of franchisees. Even if one is located, the bank trustee would undertake only the limited function of serving as a collection and disbursement agent at the direction of either the franchisor or an "advisory" board. The bank, of course, would not be called upon to make creative concept or media allocation decisions. An institutional trustee most likely would charge substantial fees for its administrative services, and the franchisor's control and flexibility with respect to the fund are likely to be diminished substantially.

Instead of an institutional trustee, the trust could be administered by a board of trustees—either employees of the franchisor, or elected or appointed franchisees, or some combination of employees and franchisees. Some franchisees who might be willing to serve on a fund board, however, might *not* be willing to serve as a "trustee" of a trust with the potential additional fiduciary obligations of such a position.[4] Their fears may be assuaged by providing for indemnification by the franchisor, as discussed below.

The trust agreement should be a general document outlining the powers and responsibilities of the trustees with respect to the trust funds. To maintain some franchisor control and flexibility regarding the detailed policies and procedures for the fund, it is suggested that the trust agreement refer to a separate policy and procedure manual. This could be amended from time to time rather easily, thereby avoiding the necessity of a formal amendment to the trust agreement. For example, the trust agreement could condition payments by the trustees from the franchisee advertising fund upon compliance with the terms of the fund manual. Conditions could include (1) that the trustees have received all approvals required by the manual prior to disbursement (e.g., the advisory board's approval and the franchisor's approval); (2) that the trustees have determined the payment is consistent with the annual budget and any other applicable advertising budget established in accordance with the terms of the manual; and (3) that the trustees are otherwise satisfied that the cost or charge is properly payable from the trust. Similar language could be included in the bylaws of a nonprofit corporation or cooperative association to regulate the responsibility of the corporation's or association's directors.

With respect to regional or local advertising cooperatives, the franchisees in the area covered by the cooperative must determine both a formula for calculating a franchisee's required contributions to the cooperative and also the allocation of voting power among the members. The contribution formula could be a flat periodic fee for each franchised location or a percentage of gross revenues; the latter is certainly more difficult to audit and enforce. Each franchisee could have one vote regardless of how many franchises he owns, or one vote for each owned franchise, or a number of votes based upon the percentage of contributions to the cooperative relative to total contributions.

IV. Industry Practice

As noted above, the authors' informal survey of franchisors found that most franchisors do not establish a separate legal entity through which fund activities are conducted. Most companies maintain a separate bank account for franchise advertising fund contributions and expenditures. Many franchisors cause the fund to reimburse them on a periodic basis for advertising-related administrative expenses. Large franchisors often have one or more employees who work full-time on fund matters and whose salaries are paid directly by the fund. In situations where a franchisor employee spends a portion of his time on fund matters and also performs administrative functions for the franchisor, the franchisor may or may not reimburse itself from the fund for an appropriate portion of the employee's salary.

Virtually all franchisors retain ultimate control over the fund, including creative concepts, media choices, and geographic allocation.

On the question of governance and control of advertising funds, the survey indicated that virtually all franchisors retain ultimate control over the fund, including creative concepts, media choices, and geographic allocation. Franchisee involvement, however, is generally considered indispensible to a healthy advertising program, whether by formal election, informal consensus, or routine consultation. All business owners, including franchisees, tend to see themselves as advertising experts for their industries, and they want to have some participation in the decision-making process, particularly regarding creative concepts.

V. Tax Issues

Where a franchisee is required to pay a portion of its gross receipts to a franchisor in exchange for rights to operate a franchise, the franchisee generally is entitled to deduct the

payments and the franchisor is required to include them in its gross income.[5] The results are significantly different where a payment is made to the franchisor in its capacity as a mere "conduit" for the collection of funds and payment to third parties. A franchisor will generally be considered a conduit when it is required to expend on a franchisee's behalf amounts received from the franchisee for specified limited purposes. Amounts received and then distributed by the franchisor, as a conduit, are treated as direct payments from the franchisee to the party that receives the payment from the franchisor. This is the typical situation with an advertising fund maintained by the franchisor, either as a separate fund or through bookkeeping entries. These principles would also be applicable if the fund were structured as a cooperative, a nonstock corporation,[6] or a separate trust.[7]

Initially, one might question the significance of franchisees' fund contributions being included in the franchisor's gross income, because there should also be offsetting deductions for fund expenditures. Like many other tax issues, the principal problem arises in timing. If the franchisor reaches the last day of its fiscal year and all of the fund monies received by it during that year have not been spent, the remaining amount may be subject to income tax. This is particularly likely in the case of a relatively new franchisor which is "stockpiling" fund contributions for a future time when the number of its franchisees reaches the appropriate "critical mass" for regional or national advertising. Similarly, an established franchisor may be accumulating payments for a major advertising campaign or a special advertising opportunity such as the Super Bowl. Any taxes paid out of the advertising fund would certainly reduce the amount available for advertising. Of more direct consequence to the franchisor, the franchisees might argue that the franchisor should use contributions only for the purpose of advertising, and consequently, it is the franchisor's obligation to pay any taxes.

Amounts received and then distributed by the franchisor, as a conduit, are treated as direct payments from the franchisee to the party that receives the payment from the franchisor.

Therefore, it is clearly important that the franchisor be deemed a "conduit" of all franchisee advertising contributions. The seminal case on this issue is a 1950 decision, *Seven-Up Co. v. Commissioner.*[8] A number of 7-Up bottlers agreed to create an advertising fund in 1943 at the suggestion of the Seven-Up Co. The participating bottlers agreed that for each gallon of 7-Up extract purchased, they would pay an additional amount to the Seven-Up Co. which would be used for advertising. Although the Seven-Up Co. commingled the advertising funds with other cash on deposit in its general bank accounts, the advertising funds were earmarked on its books for a national advertising campaign, and at all times the Seven-Up Co. had sufficient liquid assets to pay in full the unexpended balance of the advertising fund. The funds went to a single agency which handled all national advertising, and the franchisees participated in planning the campaigns. The agency made an annual report about the fund to the franchisees.

The Internal Revenue Service (IRS) contended that the payments received by the Seven-Up Co. and earmarked for advertising should be included in gross income and that the Seven-Up Co. was entitled to a deduction for advertising costs it paid from the fund. The Tax Court rejected this position and held that the bottlers' contributions did not constitute income to the Seven-Up Co. The Tax Court reasoned,

> "[the Company] did not receive the bottlers' contributions as its own property. They were burdened with the obligation to use them for national advertising. No gain or profit was realized on their receipt because of this offsetting obligation."[9]

Because the Seven-Up Co. served only as a conduit of contributions to the national advertising fund, the Tax Court characterized the transaction as payments in effect from the bottlers directly to the advertising agency which arranged the national advertising program.

In a more recent case, *Florists' Transworld Delivery (FTD) Assn.*,[10] the FTD association received payments from member retailers to establish an advertising fund and also to coordinate orders placed with one retailer for delivery in another member retailer's sales area. The association did not operate for profit, and all of the funds that it received from members were to be expended for their benefit. The IRS claimed that the payments received by the association constituted income, attempting to distinguish *Seven-Up* on the grounds that the FTD association had broader discretion concerning the manner in which it could expend funds and could exercise this discretion for its own benefit.[11]

The Tax Court rejected this distinction. It ruled that even though the association had discretion in spending the funds, this did not vitiate the association's obligation to expend the funds only on behalf of the members. Moreover, even if the association could derive some benefit from the way in which it allocated the funds, the association's role as a conduit would be unaffected so long as the association's benefit was "secondary and incidental."[12] Accordingly, the association was treated as a conduit which did not receive income.[13]

The most recent decision in the line of cases dealing with advertising funds was issued about eight years ago, and once again, the IRS lost. That case, *Frank and Freda Schochet, Trustees of Insty-Prints, Inc. National Advertising Fund Trust v. Commissioner*,[14] involved a trust agreement executed in 1973 by a franchisor which began collecting national ad-

vertising fund payments from its franchisees in 1969. Prior to the creation of the trust fund, Insty-Prints had maintained the funds in a segregated bank account and recorded the fund transactions in a separate account on its corporate books. When the trust began, the balance of the fund was transferred to the trustees by the franchisor, and all franchisee payments thereafter went directly to the trust fund. The operations of the advertising fund were directed by a committee of franchisor-appointed franchisees and franchisor representatives.

The IRS argued that the fund was not really a trust, but rather an association taxable as a corporation,[15] and should have reported the franchise payments as income. The deductions of membership organizations are limited,[16] and the effect of the government's argument would have been to tax the fund payments each year as income to the extent that amount exceeded the annual expenses. The Tax Court responded that it did not matter whether the fund was a trust or an association, as long as the franchise payments were restricted as to their use. Because "the payments were limited to use for advertising and promotion, were expended for such purpose and not for others, and no profit accrued [to the trustees],"[17] the payments were not income to the trust.

One other decision should also be noted, where a recipient of monies for a specific purpose had a very significant beneficial interest in those funds but was nonetheless characterized as a conduit. In *Angelus Funeral Home v. Commissioner*,[18] a funeral company entered into a "Pre-Need Funeral Plan Agreement" with a number of individuals. Under these agreements, the individual would make payments to the funeral company which it was required to hold in trust. Income earned on the trust corpus was distributed to the funeral home and included in the funeral home's gross income for tax purposes. Upon the individual's death, the trust corpus would be distributed to the funeral home to offset a part of the individual's funeral expense. If the individual died a sufficient distance from the funeral home so that it was impractical for the funeral home to provide the service, the trust corpus would be distributed to another funeral home selected to conduct the service.

The Tax Court concluded that the funeral home was a conduit because it was required to place the payments in trust and could not use them for its general benefit. It found the receipt of trust income by the funeral home to be equivalent to a trustee's fee. In dismissing the IRS's argument that the funeral home obtained some benefit from the amounts that it received and therefore should not be treated as a conduit, the Tax Court stated that "[t]he fact that some incidental and secondary benefit accrued to [the funeral home] is of no moment."[19] Thus, even where the recipient of trust funds had a more direct beneficial interest in those funds than a franchisor would have in national advertising fund payments, the conduit theory prevailed where the facts supported it.

In the face of forty years of precedent favorable to franchisors which operate national advertising funds, one might wonder why the tax treatment of these funds continues to be a concern. The answer is the inconstancy of the Internal Revenue Service and the resulting uncertainty for franchisors. When the opinion in *Seven-Up* was issued, the IRS acquiesced in the decision[20]; it also acquiesced in the decision in *Broadcast Measurement Bureau* soon thereafter.[21] For sixteen years, the issue remained dormant, and practitioners generally believed it was completely resolved. The controversy appeared anew, however, in the *Angelus Funeral Home*[22] case, continued through two more Tax Court cases decided in 1970,[23] and reached another culmination in the 1971 *Ford Dealers Advertising Fund*[24] decision.

Obviously, the IRS was not satisfied to let this issue die. In fact, notwithstanding its loss in all of these cases, it attacked again in 1974 by issuing a nonacquiescence in the *Ford Dealers* decision[25] and a revenue ruling clearly based on the facts of that case, but reaching the opposite conclusion.[26] This was accompanied by the IRS's withdrawal of its original acquiescence in *Seven-Up* and *Broadcast Measurement*, with a substitution of acquiescence in result only for the former case and a nonacquiescence in the latter.[27] Subsequently, another revenue ruling was issued stating the Internal Revenue Service position that if a franchisor received contributions from franchisees for a pooled advertising fund, a separate entity existed which had taxable income.[28]

Careful practitioners who are alert to the potential exposure with pooled advertising funds continue to be cautious, especially where no separate entity exists.

This position was reasserted in the later cases discussed above, and while no new controversies had made their way to a court since the *Insty-Prints* case, no one can be certain that the tax authorities will not try to resurrect this issue again. The 1974 Revenue Rulings still stand, presumably there for agents to rely on when auditing franchisors. Accordingly, careful practitioners who are alert to the potential exposure with pooled advertising funds continue to be cautious, especially where no separate entity—a trust or nonstock corporation—exists.

VI. Operational Issues

Advertising Fund Reporting

Many franchisors promise in the franchise agreement to make available to franchisees an annual statement of the operations of the advertising fund prepared by the franchi-

sor or by an independent certified public accountant. Franchise agreements also often provide that the franchisor may pay itself from the fund for its reasonable administrative costs and overhead incurred in activities reasonably related to the administration of the fund. In *Thompson v. Atlantic Richfield Company (ARCO)*,[29] franchisees sought a detailed account of their contributions to an advertising fund. ARCO provided annual information to franchisees as to total amounts collected from franchisees and total amounts spent on advertising, but it did not provide a detailed account of the advertising budget. The franchise agreement did not require any such accounting, and the ARCO offering circular specifically stated that ARCO did not plan to make disclosures to franchisees of the advertising and promotion expenditures.

A well-drafted franchise agreement contains language by which the franchise acknowledges that the advertising fund is intended to create the maximum level of general public recognition and acceptance or the trademark for the benefit of the franchised network as a whole.

The franchisees' claim for fund information was based on the theory of a trust relationship. The court found that there was no intent of the parties to create a trust relationship because, among other factors, the funds were not required to be segregated and the franchisees had no contractual power to influence the franchisor's advertising strategies. Two points are suggested by this case. The first is the importance of specific language in the franchise agreement and/or the offering circular describing what advertising fund information will and will not be provided to franchisees. Second, the court indicated that if the arrangement constituted a trust relationship, the franchisor would have a fiduciary duty to provide the franchisee with a detailed account of the fund.

Potential Liability/Indemnification

The franchisor and/or the franchisees who serve as directors or trustees of franchisee advertising funds might be exposed to a variety of claims. For example, a franchisee might sue for misuse of funds or for using bad business judgment in choosing an advertising concept or strategy. A franchisee's customer might sue for misrepresentation in advertising or on a product liability claim arising from a child's injury or death caused by a toy given out in a promotional program. A market research firm or advertising agency might sue for nonpayment of bills.

Some franchisors indemnify the franchisees who serve as fund directors or trustees. The terms of indemnification should be set forth in the corporation's or association's bylaws or in the trust agreement establishing the trust. Indemnification language should indemnify and hold harmless each board member or trustee from any claims or liabilities, including reasonable attorney's fees and expenses in defending against such matters, in respect of the acts, transactions, duties, obligations, or responsibilities which such board member or trustee performs or fails to perform as a board member or trustee in the administration of the advertising fund, excluding negligence and intentional misconduct.

Geographic Allocation of Advertising

Franchisees in certain markets may feel that their advertising contributions are not being appropriately allocated among geographic markets. A well-drafted franchise agreement contains language by which the franchise acknowledges that the advertising fund is intended to create the maximum level of general public recognition and acceptance of the trademark for the benefit of the franchised network as a whole. Accordingly, neither the franchisor nor the fund entity undertakes an obligation to place or allocate advertising programs so that they are applicable to or directly benefit a particular franchisee's business.

In *William F. Gregory et al. v. Popeye's Famous Fried Chicken and Biscuits, Inc.*,[30] franchisees complained that Popeye's failed to provide adequate advertising in the Detroit area. The appeals court upheld the district court's conclusion that the franchisees had failed to establish a *prima facie* case of Popeyes' breach of the franchise agreement. The court said that the agreement did not impose on the franchisor the duty to please individual franchisees by selecting advertising that specifically benefitted a particular market or a particular store. Further, the agreement gave the franchisor sole discretion over the timing, selection, and placement of advertising. Clearly, language like this should be included in every franchise agreement. If it is not in the franchisor's outstanding contracts, the company should consider adding a policy statement to the advertising section of its operating manual, perhaps in conjunction with a periodic update of the manual.

Advertising Agencies

Some franchisors establish their own in-house agencies which develop creative concepts, produce the actual advertisements, and place advertising with print and electronic media. In some cases, an outside agency is retained to develop and produce the advertisements, which are then placed with media by the in-house agency. Ad agencies receive a discount on print space or air time and generally charge the client the full price, thereby making a profit. A franchisor's in-house agency may choose to pass on the discount to the advertising fund so that, in effect, the fund's dollars can buy more advertising than through an independent ad agency. Alternatively, the in-house agency may be a profit center for the franchisor by charging the fund the full price for advertising. In the latter case, the franchisor should disclose in its franchise offering circular that it or its affiliate will

derive income from the placement of advertising on behalf of the franchisee advertising fund.

VII. Conclusion

The advertising fund structure and governance mechanism appropriate for a particular franchisor will depend upon the degree of control which the franchisor desires to exercise over the operations of the fund and the franchisor's level of concern regarding potential tax liability. A new franchisor usually has many issues on which to focus, and the structure of its advertising fund may not have a high priority. An established franchisor may assume that it cannot change the structure and governance of its fund, and in some cases, the franchisor actually may be bound, either by contractual language or by practical business considerations, to continue its present fund structure and/or governance format. The structural and tax issues posed by franchise advertising funds deserve closer attention from franchisor executives and their counsel, given the magnitude of the dollars involved and the critical importance of advertising to the success of most franchise networks.

Footnotes

1. *See* discussion in Fletcher Cyc. Corp. § 149 (Perm. Ed.).
2. *See* discussion in Fletcher Cyc. Corp. § 109 (Perm. Ed.).
3. BUS. FRAN. GUIDE (CCH) ¶ 9088 (Texas District Court, 1987) and ¶ 9121 (Texas District Court, 1988).
4. The fiduciary obligation of a member of a board of directors or management committee for a national advertising fund may well be just as great as that of a member of a board of trustees for such a fund. The duties would presumably be essentially the same, and the grant of authority would not be materially different. In all events, the governing instrument would define the scope of authority and responsibility for each entity and its directors/trustees, which in turn would create the foundation on which the fiduciary duties owed to beneficiaries/franchisees—and the franchisor, too—would be based.
5. I.R.C. § 1253(c), (d) (1986).
6. The tax treatment of cooperatives is covered by sections 521 and 1381–8 (subchapter T) of the Internal Revenue Code of 1988. Cooperatives are described as entities "operating on a cooperative basis" in section 1381.
7. Trusts are taxed pursuant to subchapter J, sections 641–83, of the Internal Revenue Code of 1986.
8. 14 T.C. 965 (1950).
9. *Id.* at 979.
10. 67 T.C. 333 (1976). *See also* Ford Dealers Advertising Fund, Inc. v. Commissioner, 55 T.C. 761 (1971), *aff'd per curiam*, 456 F.2d 255 (5th Cir. 1972).
11. Where a cooperative association collected funds from members which were to be used for the designated purposes of the association but were unrestricted as to a specific use or disposition, the funds were income of the association in the year in which the member's right to demand a refund either lapsed or was waived. Burley Tobacco Growers Cooperative Association, Inc. v. U.S., 22 A.F.T.R.2d 5146, 68-2 USTC ¶ 9458 (E.D. Ky. 1968). *See also* Krim-Ko Corp. v. Commissioner, 16 T.C. 31 (1951); Lake Petersburg Association v. Commissioner, T.C. Memo. 1974-55; and P.F. Schneidelman & Sons, Inc. v. Commissioner, T.C. Memo. 1965-31.
12. 67 T.C. 346.
13. Other cases which have dealt with the conduit issue include Dri-Powr Distributors Association Trust v. Commissioner, 54 T.C. 460 (1970); New York State Association of Real Estate Boards Group Insurance Fund v. Commissioner, 54 T.C. 1325 (1970); Broadcast Measurement Bureau, Inc. v. Commissioner, 16 T.C. 988 (1951); Greater Pittsburgh Chrysler Dealers Association of Western Pennsylvania v. U.S., 39 A.F.T.R.2d 77-1088, 77-1 USTC ¶ 9293 (W.D. Pa. 1977); and North Carolina Oil Jobbers Association, Inc. v. U.S., 42 A.F.T.R.2d 78-5848, 78-2 USTC ¶ 9658 (E.D.N.C. 1978).
14. 44 TCM 556, T.C. Memo. 1982-416 (1982).
15. Under section 7701 of the Internal Revenue Code of 1986, and the Regulations issued thereunder, if an entity exhibits a preponderance of such corporate characteristics as centralized management, an objective to carry on a business and divide profits, and continuity of life, it may be taxable as a corporation.
16. I.R.C. § 277 (1986).
17. Frank and Freda Schochet, *supra* at 566.
18. 47 T.C. 391 (1967), *aff'd*, 404 F.2d 210 (9th Cir. 1969).
19. *Id.* at 395.
20. 1950-2 C. B. 4.
21. 1951-2 C. B. 2.
22. Angelus Funeral Home v. Commissioner, *supra*.
23. Dri-Powr Distributors Association Trust v. Commissioner, *supra*, and New York State Association of Real Estate Boards Group Insurance Fund v. Commissioner, *supra*.
24. Ford Dealers Advertising Fund, Inc. v. Commissioner, *supra*.
25. 1974-2 C. B. 5.
26. Rev. Rul. 74-318, 1974-2 C. B. 14.
27. 1974-2 C. B. 4.
28. Rev. Rul. 74-319, 1974-2 C. B. 15.
29. 673 F. Supp. 1026 (W.D. Wash. 1987).
30. BUS. FRAN. GUIDE (CCH) ¶ 9213 (6th Cir. 1988).

franchise law journal

American Bar Association
Forum on Franchising
750 North Lake Shore Drive
Chicago, IL 60611

Volume 10, Number 2, Fall 1990