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Avoiding the Franchise & Business Opportunity Law Traps

Distribution Laws

Since the passage of the 2018 Farm Bill, distribution and retail activities involving Hemp have grown at an accelerated pace. Now, distributors of Hemp, like distributors in virtually every other industry have, are incorporating franchising within their business model. This should come as no surprise given that franchising has proven to be an effective and cost-efficient method of distributing products and services. However, after factoring in the administrative requirements of franchising, many distributors decide that franchising is not for them. For these distributors, it is imperative that they are aware of and understand franchise and business opportunity laws (the “[Distribution Laws](#)”), so that they can structure their arrangements to avoid any inadvertent application of these laws.

Franchise & Business Opportunity Traps

Many distributors do not recognize the scope of Distribution Laws and how easily these laws attach to run-of-the mill commercial arrangements like supplier agreements, distribution agreements, licensing agreements, dealer agreements, and reseller agreements. By the time a distributor becomes aware of Distribution Laws, they are already “trapped” and obligated to comply with these laws even though they sought to avoid them. No distributor or retailer wants to be caught-up in this particular “trap.”^[1] Accordingly, this blog provides some general information on how franchises and business opportunities are defined and thoughts on how to avoid having these laws apply to a distributor’s commercial arrangements.

Definitions of a Franchise & Business Opportunity

The definitions of a “**franchise**” and “**business opportunity**”^[2] are very expansive and vary from federal to state and from state to state. But, generally,

- a **franchise** exists when a distributor (1) grants a third party ("Licensee") a right to use the distributor's trademarks ("Trademark Element"), (2) provides assistance to, or imposes controls, on how the Licensee operates the business under the arrangement ("Control/Assistance Element"), and (3) requires the Licensee to pay the distributor under the arrangement ("Payment Element"); and
- a **business opportunity** exists when (1) a third party ("Operator") purchases products or services from the distributor ("Purchase Element"), (2) the Operator uses the products and services to begin or continue to operate a business ("Business Use Element"), and (3) the distributor makes certain representations about the business to the Operator ("Representation Element").^[3]

If Distribution Laws apply, then the distributor must prepare and provide a disclosure document to Licensee/Operator and comply with all other legal obligations under the Distribution Laws.

Avoiding the Application of Distribution Laws

To avoid application of Distribution Laws, a distributor has the following two (2) options:

- **Structure the arrangement to avoid at least one of the definitional elements.** To avoid **franchise laws** the distributor will need to structure the arrangement to eliminate either the Trademark Element, Control/Assistance Element, or the Required Payment Element. To avoid **business opportunity laws**, the distributor must structure the arrangement to remove either the Purchase Element, Business Use Element, or and Representation Element; and/or
- **Find an applicable exemption.** If the distributor is unable or has no desire to restructure its arrangement, then the distributor will need to satisfy an applicable exemption for the arrangement in each jurisdiction where the arrangement was offered as well as the jurisdiction where the Operator operates the business.^[4]

Takeaways

Any distributor, whether in the Hemp industry or not, should engage competent franchise counsel to help them navigate and comply with the complex and varying patchwork of Distribution Laws. Non-compliance is not a viable option, considering that any violations (1) will subject the distributor to serious consequences, including civil and criminal actions by federal and state agencies, damages, recession claims, and cease and desist orders, (2) may subject the owners and directors of the distributor to personal liability, (3) may negatively affect the enterprise value of the distributor, and (4) may cause the distributor to be in default of standard compliance of law provisions set forth in its loan, lease, or other material agreements.

As always, we at Frost Brown Todd are here to help you.

[1] Unless of course, they are distributing music or visiting 2 Chainz's trap house: <https://www.ajc.com/news/world/chainz-brings-pink-trap-house-back-atlanta-for-holiday-season/efxxANsGbvjKQ3zsNIQvRL/>

[2] The nomenclature of the arrangement and intent of parties are irrelevant. If the arrangement satisfies the definitional elements, then it will be deemed a franchise or business opportunity.

[3] Threshold representations include the distributor agreeing to assist in procuring customers, providing operational support, or buying back products and services, as well as the distributor making financial performance claims.

[4] The Exemption types and requirements differ from jurisdiction to jurisdiction.

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