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# Trademark Licensing: Avoiding the Accidental Franchise in Structuring Licenses

Navigating Differences Between Trademark Licenses and Franchises, Avoiding Naked Licenses

THURSDAY, OCTOBER 13, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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## Marketing Plan

**There must be a licensed mark in a franchise relationship and, because a mark may be abandoned if it is not subject to quality control standards, there will always be some controls imposed on a user of a mark. Every arrangement is unique and varying combinations of elements may lead to varying results. State laws differ.**

### Weak Indication

- ☐ Instructions on the font, color and appearance of the licensed mark.
- ☐ Limitations aimed only at consistent representation of the mark to the public.
- ☐ Requirement that advertising must be approved by the licensor.
- ☐ Restrictions on the association of the mark with other businesses or marks.
- ☐ Limitations on the quality of materials upon which the mark appears.
- ☐ Limitations on the use of the mark in advertising and marketing materials.
- ☐ Restrictions on use of the mark similar to restrictions by competitors who do not operate as franchises.
- ☐ The imposition of territorial restrictions. Although this has been viewed as evidence of a marketing plan, such restraints are now common in many licensing arrangements that are not franchises.

### *Factors That May Support a Marketing Plan*

**Although individual factors may not be enough to meet the marketing plan element, a combination of factors may establish a marketing plan. The combination is qualitative, rather than merely quantitative, in the sense that there is no set number of factors that can be said to establish a marketing plan.**

- ☐ Architectural plans imposed so that all outlets appear to be under common ownership to members of the public.
- ☐ Detailed restrictions on retail operations that do not appear to be aimed at quality control as to products or services associated with the licensed mark.
- ☐ Training on matters related to the day-to-day operation of the licensed business.
- ☐ Providing a training manual.
- ☐ Right to approve the location chosen by the licensee.
- ☐ Offering advice on how to set up the licensee's business.
- ☐ Having field representatives drop in on the licensee to offer advice from time to time.
- ☐ Having regular meetings the licensee is required or invited to attend.
- ☐ The imposition of standards typical in the industry among non-franchised businesses.
- ☐ Requiring the licensee to service national accounts on terms established by the licensor.
- ☐ Requiring the licensee to honor coupons issued by the licensor or other licensed locations.
- ☐ Requiring the licensee to participate in special promotions.
- ☐ Requiring the licensee to honor gift certificates.
- ☐ Control over the hours the licensed business must be open.

- [ ] Providing trade secrets.
- [ ] Imposing sales quotas.
- [ ] Ongoing advice related to the licensee's employees.
- [ ] Telling prospective licensees that there is a successful marketing plan, even if one is never provided.
- [ ] Providing some suggestions as to how the licensee's business should be marketed, even if the suggestions are not made until after the licensee opens for business, and the suggestions are not mandatory and the licensee does not, in fact, follow the suggestions.
- [ ] Providing or requiring the use of a bookkeeping or other ''back office'' system the licensee must use in the operation of the licensed business.
- [ ] A 1-800 number that directs customers to the licensee.
- [ ] An Internet web site that directs customers to the licensee.
- [ ] Employees are required to wear uniforms.
- [ ] Employees are required to follow a script in interacting with customers.
- [ ] The licensee is not allowed to operate other businesses.
- [ ] The licensee is subject to an in-term covenant against competition.
- [ ] Restrictions on the right to carry goods made by competitors.

**Strong Evidence Supporting a Marketing Plan**

- [ ] Quality control audits that focus on the day-to-day operations of the licensed business.
- [ ] A written marketing plan for the licensee's operation of its business.
- [ ] Extensive training covering all aspects of the licensee's business operations.
- [ ] Imposing rules on aspects of the licensee's business that go beyond assuring the quality of the goods, in the case of trademarks, or services, in the case of service marks, associated with the licensed marks.
- [ ] Interference with the licensee's day-to-day operation of the licensed business in ways that would subject the licensor to vicarious liability.
- [ ] The licensee is subject to a post-term covenant against competition.

### *Fee Element*

**Unlike the marketing plan element, there need not be several different kinds of fees. Any single fee exceeding the statutory minimum is sufficient to meet the fee element.**

**Not Indicative of a Fee**

- [ ] Payments made to third parties unrelated to the franchisor that do not satisfy an obligation the licensor would have otherwise been required to make.
- [ ] Loans from third parties to the licensee related to the licensed business.
- [ ] Hours invested by the franchisee and family members in operating the licensed business.
- [ ] Rent payments to unrelated third parties.
- [ ] The cost of equipment purchased from unrelated third parties.
- [ ] The cost of goods purchased from the licensor or a related company as long as the cost is at a bona fide wholesale cost and the required amount is reasonable.
- [ ] The sale of reasonable quantities of inventory at prices that allow the licensee to take a standard markup in making retail sales.

- ☐ Payments made to a third party which allow both licensor and licensee to take advantage of a volume discount when sales to both parties are taken into account.
- ☐ Commissions paid to the licensee by the licensor.
- ☐ Payments to the licensor that are not mandatory and where the licensee has meaningful available alternatives.
- ☐ Customers of the licensee make payments to the licensor.
- ☐ Freight charges passed through from unrelated third-party shipping companies.

**May Be a Factor Supporting a Fee**

- ☐ Any direct payment to the franchisor or for the benefit of the franchisor is suspect.
- ☐ Ancillary transactions in which the licensor and licensee share customer revenues.
- ☐ The franchisor's pass through of third-party costs to the licensee may be a fee depending on the details of the arrangement between the parties.
- ☐ Requiring the licensee to make purchases of inventory in unreasonable quantities.
- ☐ Controls over resale pricing, including minimum and maximum retail price setting.
- ☐ A required deposit that is held with no interest or commingled with the licensor's own funds.
- ☐ Requiring the licensee to purchase generic products from the licensee or an affiliate at inflated prices.
- ☐ In some states, in some circumstances, ordinary business expenses are not considered franchise fees.
- ☐ Costs for brochures, manuals, displays or advertising collateral.
- ☐ Any payment by the licensee that ends up in the hands of the licensor, no matter what it is called, might be a franchise fee.
- ☐ Deductions from commissions paid to licensees may not be fees if they are part of the overall commission formula.
- ☐ Palletizing charges or fees for shipping, packaging or support services provided by the franchisor or its affiliate.
- ☐ A payment to the licensor for rent.
- ☐ Fees charged by the licensor to set up the licensee for business.

**Strong Evidence of a Fee**

- ☐ An up-front payment to the licensor.
- ☐ Continuing payments in the form of royalties.
- ☐ Payments by licensees to a third party, allowing the licensor to obtain some benefit it might otherwise have had to pay for.
- ☐ Any required, non-recoverable investment made by the licensee in the licensor.
- ☐ Payments by the licensee into a marketing fund for the licensed brand.
- ☐ Requiring the licensee to purchase displays, equipment or furniture from the licensor or an affiliated company, even if the price is reasonable or does not exceed the purchase price paid by the licensor.
- ☐ Payment to the licensor for services necessary to operate the business.
- ☐ Payments to the licensor for supplies.

***Community of Interest***

**Factors Which May Establish the Community of Interest**

- ☐ A disparity in bargaining power.
- ☐ Controls exercised by the licensor over the licensee.
- ☐ The relative obligations of the parties to one another.
- ☐ The percentage of time the licensee devotes to the licensor's products.
- ☐ The personnel of the licensee devoted to selling the licensor's products.
- ☐ The extent of the use of the licensor's marks in the licensee's business.
- ☐ The amount spent by the dealer on advertising the licensor's products.
- ☐ The extent of the ancillary services provided by the licensee to purchasers of the licensor's products.
- ☐ Granting of a territory.
- ☐ Joint marketing efforts.
- ☐ The degree to which the parties have cooperated in coordinating their activities to achieve common goals.
- ☐ Whether there is a sharing of revenues from a common source.
- ☐ Requiring the licensee to provide financial statements to the licensor.
- ☐ Interdependence of the parties on one another.
- ☐ The licensee has invested in fixed assets, advertising or training that is focused on the licensor's goods and services.
- ☐ An in-term covenant not to compete.

**Strong Evidence**

- ☐ The licensee has made a brand-specific investment and is dependent on continued affiliation with the brand to recoup the investment.
- ☐ The licensee's sunken costs in the relationship with the licensor.
- ☐ A large proportion of the licensee's income is derived from selling the licensor's products.
- ☐ The licensee is economically dependent on the licensor.
- ☐ The licensor has the right to receive the kind of documentation from the licensee that is ordinarily the kind of information limited to attorneys, accountants and bankers.
- ☐ Extensive controls over the licensee going beyond those that appear to be necessary to maintain brand standards.
- ☐ Controls over the day-to-day operations of the licensee.
- ☐ A long-time relationship.
- ☐ Granting of an exclusive territory.
- ☐ A post-term covenant not to compete.

# Expert Q&A on Trademark Licensing and Accidental Franchises

Companies that distribute branded goods or services through independent contractors or license their brands are often surprised to discover that these commercial arrangements are actually franchises subject to extensive regulation. Practical Law asked *Rochelle Spandorf* of *Davis Wright Tremaine LLP* to discuss franchising regulation, the legal consequences for an inadvertent franchisor, and how to structure commercial relationships to avoid "accidental" franchise status.

**ROCHELLE B. SPANDORF**
PARTNER
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Shelley is a nationally recognized business franchise and distribution attorney with more than 35 years of experience representing franchisors, manufacturers, licensors, suppliers, franchisees, and distributors in their domestic and international expansion and strategic development. She concentrates her practice on a broad spectrum of transactional and regulatory issues for clients in all industry sectors, from startups to mature public companies.

## What is a franchise?

Most people think they know a franchise when they see one (for example, restaurants with golden arches). In fact, franchising is a method of distribution that is not limited to a particular industry. Each time a trademark license, product distributorship, dealership, strategic brand alliance, or comparable marketing affiliation is formed (whether the subject is fast food restaurants, fitness centers, convenience stores, beverages, clothing, car rentals, automobile dealerships, gas stations, delivery routes, or real estate services) the cornerstone of a franchise potentially is laid.

There is no uniform definition of a franchise. While federal and state franchise laws share common definitional approaches, each jurisdiction has its own subtleties and mix of exclusions and exemptions. What qualifies as a franchise under federal law may not qualify under state laws and vice versa. A franchise in one state may not be a franchise in all states that regulate where that business operates.

At the most basic level, a franchise is defined by the coexistence of three elements:

- **A trademark license.** This element involves a grant of rights to use another's trademark to offer, sell, or distribute goods or services. While not every trademark license creates a franchise, every franchise has some form of trademark license.
- **A marketing system.** Depending on the jurisdiction, this element takes one of three variations, but all focus on the licensor's assistance with, or control over, the licensee's entire method of operation causing the public to regard all

 

licensed outlets as a unified marketing concept. In some states, the required assistance or control may take the form of a prescribed marketing plan or what some jurisdictions more broadly describe as a "community of interest."

- **A franchise fee.** This element involves payment of a required fee by the licensee.

Franchise status hinges entirely on whether an arrangement meets the applicable statutory definition. The legal analysis considers:

- The parties' actual practices.
- Oral and written promises.
- Course-of-dealing evidence.

A party cannot avoid a franchise relationship simply by disclaiming its existence. If the statutory definitional elements coexist, the relationship is a franchise even if the parties studiously avoid using the term in referring to their arrangement.

## How do accidental franchise claims arise?

Typically, accidental franchise claims arise after a distribution or licensing arrangement falls short of the distributor's or licensee's expectations or the licensor terminates the contract without cause as permitted by the parties' contract. In some cases, accidental franchise claims are brought by unhappy distributors, licensees, or dealers to prevent a licensor or supplier from imposing network-wide changes. Unhappy licensees and a licensor's competitors will often tip off government agencies about franchise law violations they believe have taken place, ultimately leading to public enforcement actions on behalf of injured licensees.

Accidental franchises are also exposed in the due diligence process that accompanies the sale of a company or strategic investment by private equity or venture capital firms. Questions about compliance with franchise laws in forming or ending licensing agreements may torpedo a lucrative deal. Even if the transaction proceeds, investors may insist on lowering the purchase price, staggering payouts, requiring personal guarantees, or other price adjustments. Consequently, accidental franchises are potentially costly mistakes.

## What are some examples of business arrangements challenged as franchises?

Remarkably diverse business arrangements have been challenged as franchises, including established organizations and sophisticated companies. For example:

- The Seventh Circuit enjoined the national Girl Scouts organization from ending its relationship with a local Girl Scouts chapter after finding that the parties' arrangement was subject to the Wisconsin Fair Dealership Law, which protects dealers and franchisees alike against termination without good cause (*Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the U.S. Inc.*, 549 F.3d 1079 (7th Cir. 2008)).
- Global fashion brand, Gap, was sued by its exclusive distributor in the Middle East for wrongful termination under the California Franchise Relations Act, which requires good cause to end a franchise relationship, after Gap changed its international distribution strategy and terminated the parties' distribution agreement without cause as expressly permitted by the contract. Three years after losing a motion to dismiss the franchise claim, Gap finally won on summary judgment holding that the distribution arrangement was not a franchise. However, Gap spent considerable time and resources to reverse the preliminary ruling. (*Gabana Gulf Distrib., Ltd. v. Gap Int'l Sales, Inc.*, 2006 WL 2355092 (N.D. Cal. Aug. 14, 2006), summary judgment granted to defendant, 2008 WL 111223 (N.D. Cal. Jan. 9, 2008), aff'd, 343 F. App'x 258 (9th Cir. 2009).)
- Rental companies Avis and U-Haul and car manufacturer Isuzu were each sued under franchise laws by their respective authorized dealers. After years in court, each successfully defeated franchise status claims. (*Thueson v. U-Haul Int'l, Inc.*, 50 Cal. Rptr. 3d 669 (Cal. Ct. App. 2006); *Adees Corp. v. Avis Rent A Car Sys., Inc.*, 157 F. App'x 2 (9th Cir. 2005); *JJCO, Inc. v. Isuzu Motors Am., Inc.*, 2009 WL 1444103 (D. Haw. May 22, 2009).)
- Bakery route drivers have sued their suppliers for violating franchise laws to prevent changes to route assignments (*Atchley v. Pepperidge Farm, Inc.*, 2012 WL 6057130 (E.D. Wash. Dec. 6, 2012); *Petereit v. S.B. Thomas, Inc.*, 63 F.3d 1169 (2d Cir. 1995)).

## Taking each definitional element in turn, is an express trademark license required in a franchise relationship?

No. The trademark element in federal and state franchise definitions varies from requiring a "license to use" the licensor's trademark to requiring a "substantial association" between the licensee's business and the licensor's trademark. The license to use a trademark may be express or implied. For example, each of the following fact patterns may satisfy the trademark element:

- A distribution or dealership agreement that authorizes an independent contractor to sell branded products or services. The arrangement is a de facto or implied trademark license if branded sales account for more than an insignificant percentage of the dealer's or distributor's overall sales.
- Marketing that associates a dealer's business with a supplier's brand, even when the trademark is not part of the licensee's trade name. For example, "Smith's Appliances, an authorized Brand X Service Center."
- Permission to display a manufacturer's logo or commercial symbol in dealings with customers.
- Longstanding use of a licensor's trademark in dealings with customers, even without explicit contract authority.

## How do the factors that identify a franchise relationship differ from standard trademark license quality controls?

The federal Lanham Trademark Act provides that a mark is deemed abandoned when the owner's course of conduct causes the mark to lose its significance as a mark (15 U.S.C. § 1127). To avoid abandonment, a trademark license will commonly specify standards designed to ensure the quality and uniformity of goods and services associated with a licensee's use of the licensed brand. A trademark owner's failure to control the quality and uniformity of goods and services associated with a licensee's use of the licensed brand may result in abandonment of its trademark rights (*Barcamerica Int'l USA Trust v. Tyfield Imps., Inc.*, 289 F.3d 589 (9th Cir. 2002)).

As a practical matter, it is often difficult to distinguish trademark quality controls from the tell-tale facts that satisfy the marketing control element, which vary across jurisdictions. Depending on the particular jurisdiction, the marketing system definitional element may take one of three forms, each of which emphasizes different facts:

- Substantial control by, or significant assistance from, the licensor.
- A marketing plan that is prescribed in substantial part by the licensor.
- A community of interest between the licensor and licensee.

All three definitional variations are inherently subjective and, consequently, difficult to dodge in a written agreement. Courts and franchise agencies disagree on which and how many facts must coexist to prove the marketing system definitional element.

### What are some examples of substantial control by, or significant assistance from, a licensor?

The federal franchise law and one state franchise sales law (South Dakota) require a licensor to impose substantial control over the licensee's entire method of operation, or furnish the licensee with significant assistance, in order for a license to qualify as a franchise. Substantial control may be found if the licensor:

- Approves or restricts the licensee's business location or sales territory.
- Sets minimum operating hours for the licensee.
- Restricts a licensee's customers.
- Forbids the sale of competitive products.
- Mandates service standards.
- Dictates mandatory accounting practices or reporting requirements.
- Specifies design or appearance requirements.
- Establishes production methods or standards.

Significant assistance may be found when a licensor provides:

- Formal sales, repair, or business training programs.
- Site location assistance.
- Management, marketing, or personnel advice.
- Operating advice, such as by furnishing a detailed operating manual.
- Promotional support requiring the licensee's participation or financial contribution.

Under certain circumstances, any one of these factors may be enough to constitute substantial control or significant assistance. Promises of significant assistance, even if unfulfilled, will satisfy this element.

### What type of marketing plan must be in place for a franchise to exist?

A number of states (California, Illinois, Indiana, Iowa, Maryland, Michigan, North Dakota, Oregon, Rhode Island, Virginia, Washington, and Wisconsin) define a franchise as a trademark license in conjunction with a marketing plan that is prescribed in substantial part by the licensor. The requisite marketing plan is not about traditional marketing or advertising support per se. Rather, its concern is with guidance, standards, or requirements that promote uniformity among independently owned establishments licensed to use a common brand. In practice, the marketing plan and significant assistance/substantial control definitional approaches are alike and established by similar facts.

Court rulings differ with respect to the degree of a licensor's involvement in a licensee's daily business activities necessary to find a marketing plan. Depending on the jurisdiction, a marketing plan may be found based on a licensor's:

- Requirements or restrictions that:
  - confine licensee sales to an assigned territory;
  - impose sales quotas;
  - mandate sales or other minimum training; or
  - give detailed instructions for customer selection and solicitation.
- Recommendations, advice, or provision of materials, even when there is no obligation on the licensee's part to observe or use them, such as:
  - suggesting resale prices and discounts;
  - providing demonstration equipment or advertising materials;
  - recommending or screening advertising materials; or
  - providing product catalogs.

### How do states define the community of interest element?

Several states (including Hawaii, Minnesota, Mississippi, Nebraska, and New Jersey) follow the community of interest approach, but differ in how they define this element. Nevertheless, all community of interest states recognize that a community of interest exists when both parties derive revenue from the licensee's sale of branded goods and services, a standard that potentially encompasses every trademark license.

### For the franchise fee element, what types of payments to a licensor constitute a franchise fee?

The franchise fee element captures all revenue a licensee pays to a licensor for distribution or licensing rights. This element is deliberately expansive, encompassing lump-sum, installment, fixed, fluctuating, up-front, and periodic payments for goods or services, however denominated, whether direct, indirect, hidden, or refundable.

The federal definition of a franchise requires the licensee to pay more than $500 within its first six months of operation.

Under certain state franchise or dealer relationship laws, an arrangement that is not a franchise at inception may become one later if a licensee's combined incremental payments to a licensor exceed the statutory fee threshold. The idea that a non-franchise relationship can turn into a franchise over time adds uncertainty to the status of licensing and distribution arrangements.

### What factors are relevant to proving that a payment is a franchise fee?

The franchise fee element involves payment of a required fee by the licensee. To be classified as a required fee, the payment must be:

- **Made to the licensor or its affiliate as consideration for the licensing or distribution rights.** For this reason, commissions that a licensor pays to a licensee are not franchise fees because no money flows from the licensee to the licensor.
- **For the benefit of the licensor or its affiliate, if made to a third party.** However, an indirect franchise fee exists if, for example, a:
  - licensee must discharge the licensor's debt to a third party (such as by paying rental fees to an unaffiliated equipment lessor for equipment that the licensor supplies to the licensee); or
  - licensor receives revenue from third parties that deal with the licensee (such as referral fees from recommended suppliers).
- **Essential for the successful operation of the licensed business.** Fees paid for sales training, display equipment, or marketing tools, though nominally optional, are highly suspect under this standard because use of these items is designed to improve a licensee's performance and outcome. When substantially all licensees opt in to a so-called discretionary program and rarely, if ever, opt out, a licensor may face difficulty proving the so-called voluntary payments are truly optional.

All jurisdictions exclude from the scope of a required fee any payments that do not exceed the bona fide wholesale price of inventory if there is no accompanying obligation to purchase excessive quantities. To qualify for this exclusion, the payment must be entirely for goods for which there is a ready market. Most suppliers rely on this exclusion in structuring non-franchise product distributorship or dealership programs. The exclusion requires suppliers to avoid charging fees for other services offered to distributors or dealers, like fees for training, accounting support, sales tools, display equipment, equipment rentals, software licenses, or uniforms.

### If franchise status cannot be avoided, what are the key laws that a licensor must comply with?

Broadly speaking, there are two types of franchise laws that apply to all commercial arrangements regardless of industry:

- **Franchise sales laws.** These federal and state laws govern the formation of franchise relationships and impose stringent presale disclosure requirements. State franchise sales laws also impose some type of duty to file or register with a designated state franchise agency.
- **Franchise or dealer relationship laws.** These state laws govern the substantive terms of the parties' relationship and require good cause for termination or non-renewal, and other substantive contract conditions.

At the federal level, franchise sales in all 50 states are regulated by the Federal Trade Commission. Federal law requires a franchisor to deliver a comprehensive disclosure document to a prospective franchisee at least 14 days before the franchisee pays any money or signs any binding agreement for the franchise rights. Federal law prohibits providing prospects with historical or future earnings information about the opportunity unless financial representations comply with disclosure standards. There is no federal registration duty or relationship law.

Currently, over a dozen states have state franchise sales laws that go beyond the federal presale disclosure duty and require franchisors to register with a state franchise agency before offering or selling a franchise either:

- To a state resident.
- For a location or territory in the state.

About 24 states also have franchise or dealer relationship laws that forbid termination without good cause, adequate notice, or more. These laws override conflicting provisions in the parties' agreement. For example, even if the parties' license agreement allows termination without cause on 30 days' notice, a state franchise or dealer relationship law that requires cause, or a longer notice period, or both, controls.

Some states go further and forbid a franchisor from exercising contractually reserved rights to change the distribution model, remove territory, or impose other competitive changes short of termination. Some states nullify contract provisions that prevent a franchisee from selling distribution rights to a qualified buyer. Franchise laws void a franchisee's waiver of statutory protections even when the waiver is given on the advice of legal counsel in exchange for other contract concessions.

On the other hand, if a state law permits termination on grounds not covered in the parties' contract, a franchisor may not use the statute to end a license agreement for reasons contrary to the parties' bargain. Franchise laws protect franchisees. They do not vest franchisors with additional rights not expressed in the parties' contract.

There are numerous state industry-specific laws that are similar to state relationship laws, but only protect the licensees, franchisees, distributors, and dealers who operate in those industries, such as:

- Wine, beer, and alcoholic beverages distributors.
- Automobile dealers.
- Heavy equipment and farm equipment dealers.

### What are the dangers of not complying with applicable franchise laws?

Franchise law violations carry significant penalties even when the inadvertent franchisor neither knew about the law nor intended to violate it. Not only is it a felony to sell a franchise without complying with franchise sales law, but federal and state agencies have broad powers to penalize franchise law violators, including by:

- Freezing their assets.
- Ordering restitution to the franchisee.

- Issuing cease and desist orders.
- Banning them from selling franchises.
- Assessing substantial fines.

Franchisees also have private remedies for state franchise law violations, and some laws permit franchisees to recover compensatory damages, and also treble damages, lost profits, and attorneys' fees.

Additionally, an injured franchisee may:

- Rescind a franchise agreement for disclosure and registration violations.
- Obtain an injunction to stop the wrongful termination or nonrenewal of a franchise.
- Recover damages or restitution.

State franchise laws impose joint and several personal liability on the franchisor's management and owners even when the franchisor is a legal entity.

While the federal franchise law does not provide franchisees with a private right of action, injured franchisees can find remedies under many state unfair trade practices laws by relying on violation of the federal franchise law as the predicate unfair practice.

Additionally, counsel who overlook franchise laws may be guilty of malpractice and potentially liable to victims of their clients' wrongdoing.

### Why are accidental franchises so prevalent?

The increasing importance of branding to consumer buying decisions explains why accidental franchises occur more frequently today than when franchise laws were first enacted in the 1970s. Accidental franchises are also the by-product of franchise laws that poorly articulate the distinction between non-franchise and franchise licenses.

Further, because franchise status is highly fact dependent, franchise claims are easy to allege and tend to resist pretrial motions to dismiss. This, combined with the potential joint and several personal liability of a licensor's management and owners, make franchise claims particularly attractive to plaintiffs looking for settlement leverage in disputes with a licensor.

### How can a company minimize the risk of creating a franchise relationship when structuring a brand-related commercial arrangement?

Structuring a commercial arrangement so that it lacks one of the definitional elements will prevent a franchise finding regardless of how extensively the other elements are present in the parties' relationship.

One structuring solution is to eliminate the required fee. For example, a licensor may avoid the required fee:

- **In a product distributorship or dealership arrangement when the goal is to move goods downstream to the ultimate consumer.** In this situation, a licensor can avoid franchise regulation by limiting its compensation to the difference between its cost of goods and the bona fide wholesale price at which it sells the branded goods to distributors or dealers (its mark-up). Courts have been reluctant to look behind a manufacturer's or supplier's wholesale price or find a franchise fee hidden in a bloated mark-up. This structuring solution is not available to licensors of services businesses, like fast food restaurants, fitness centers, pet services, or tax preparation businesses.
- **By setting up a commission arrangement or otherwise structuring the money flow to avoid payments from the licensee to the licensor.** Avis, U-Haul, Pepperidge Farm, and others have successfully defeated franchise claims by structuring the money flow to travel from licensor to licensee, or by arranging for network members to buy tools or services essential for operation from unrelated third parties. However, this structuring solution has its disadvantages. For example:
  - while licenses involving services businesses may use this structuring solution, most licensors find a commission arrangement highly impractical; and
  - commission arrangements often create agency relationships, which increase the licensor's liability risks to third parties for the licensee's wrongdoing.

Under federal law, licensors can avoid franchise status by deferring required licensee payments over $500 for at least six months after the licensee or distributor begins operations. However, this exemption has no counterpart in states with their own franchise laws. A short-term deferral of fees, therefore, is not a universal solution for avoiding franchise status.

In many cases, no structuring solution can save a commercial arrangement from franchise regulation. Moreover, roughly ten state franchise and dealer relationship laws define a franchise by a two-prong test that omits either the marketing plan or, more commonly, the payment of a required fee. These state laws regulate ordinary distributorships, dealerships, and licenses, even those that do not qualify as franchises under the federal franchise law because there is no federal preemption of state laws.

Counsel should never rely on contract terminology or disclaimers, neither of which will defeat franchise status. While contract drafters are not without tools, they must know which structuring options are viable and which ones are simply too costly or risky in the long run.

Licensors should keep the burdens of being deemed a franchisor in perspective. Numerous companies comply with federal and state franchise laws and sustain and grow successful, viable businesses. Structural solutions often come at the price of sacrificing essential economic objectives or competitive opportunities.

Because franchise status requires a technical evaluation of a commercial arrangement under potentially multiple laws with subtle distinctions, accidental franchises are a trap for the unwary. Counsel who assume they know a franchise when they see one may be as surprised as their clients to discover the breadth of franchise laws.

# Structuring Licenses to Avoid the Inadvertent Franchise

## By Rochelle Spandorf

Trademark licensors beware. Is your license or distribution agreement really a franchise?

In *Gentis v. Safeguard Business Systems*,[1] a business forms supplier retained commissioned sales agents to solicit orders, follow leads, and provide customer service. While the agents did more than just take orders, they lacked authority to enter into binding sales contracts with customers, bought no inventory, seldom made deliveries, and did not handle customer billing or collection. When the parties' relationship soured, the agents sued the supplier for violating California's Franchise Investment Act, the first franchise sales law in the country and the model for the federal and state franchise sales laws that followed. To the supplier's surprise, the California appellate court found the relationship to be a franchise.

In *Charts v. Nationwide Insurance Co.*,[2] a Connecticut federal district court found an insurance agency to be a franchise and concluded that Nationwide had wrongfully terminated the agency without good cause in violation of Connecticut's Franchise Act, justifying a $2.3 million judgment award. While the judgment was eventually reversed three years later on different grounds,[3] it temporarily rocked an industry that never seriously considered that insurance agents might be franchisees.[4]

In *Gabana Gulf Distribution Ltd. v. Gap International Sales, Inc.*,[5] a U.K. company appointed as Gap International's exclusive distributor in the Middle East sued the apparel giant for wrongful termination under California's Franchise Relations Act after Gap changed its international distribution strategy and terminated the parties' distribution agreement without cause as expressly permitted by the contract. Claiming its relationship with Gap was a franchise, the distributor sought protection under California's statute that requires good cause to end a franchise relationship. Three years after Gap lost its motion to dismiss the franchise claim, Gap finally prevailed on summary judgment holding the distribution arrangement was not a franchise, but it spent considerable time and resources to reverse the preliminary ruling.

Even the Girl Scouts have been ensnared by the franchise dragnet! In *Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the United States of America Inc.*,[6] the Seventh Circuit enjoined the national Girl Scouts organization from ending its relationship with a local council after finding the parties' arrangement fell within Wisconsin's fair dealership law, which protects dealers and franchisees alike against termination without good cause.

These decisions involve different, but typical, distribution and licensing arrangements for the offer, sale, or delivery of branded goods or services identified by the seller's trademark. In none of these cases did the parties intend to form a franchise relationship. No investor paid cash to the licensor up front or any type of monthly fee based on gross receipts for the distribution or licensing rights. Certainly no licensor expected to end up defending franchise allegations.

Yet, these situations arise with considerable frequency. Manufacturers, suppliers, and other trademark owners overlook a possible franchise connection when they enter into relationships with independent third parties to sell their branded products or services.[7] Embedded in these distribution arrangements is a de facto trademark license. While not every trademark license creates a franchise, every franchise contains a trademark license.

Given the prevalence of franchising and the interstate, national, and even international scope of so many franchise networks today, attorneys need to know about potentially applicable federal, state, and foreign franchise laws. Franchise sales in the United States are subject to dual regulation at the federal and state level, depending on where the parties reside or do business. The federal franchise sales law, originally adopted in 1978 and overhauled in 2007 regulates franchise sales in all 50 states, including wholly intrastate transactions, per the 2007 version of 16 C.F.R. § 436 (hereinafter "Amended FTC Rule").[8]

Sorting franchise from nonfranchise licenses can be a highly uncertain process. The quality controls that trademark owners *must* retain over a licensee's trademark use closely resemble the marketing controls that are characteristic of a franchise. Yet, from a regulatory viewpoint, nonfranchise and franchise licenses are as different as day and night.

Nonfranchise licenses are unregulated private consensual arrangements. Franchises, by contrast, are highly regulated. Franchise sellers must obey elaborate federal and state presale disclosure and registration laws; nonfranchise licensors do not. Many states restrict the conditions under which a franchise may be terminated or not renewed. Some states dictate substantive terms for the franchise relationship. A franchisee cannot waive the statutory protections of franchise laws even if it wants to. A terminable-at-will contract clause cannot be enforced in a jurisdiction that requires good cause to terminate a franchise agreement—even if the franchisee's attorney actively negotiated the contract.

Franchise law violations carry significant penalties even if the inadvertent franchisor neither knew about the law nor had any intent to violate it. Not only is it a felony to sell a franchise without complying with a franchise sales law, but federal and state franchise agencies have broad powers to punish franchise law violators and may freeze assets, order restitution, issue cease and desist orders, ban violators from selling franchises, and recover substantial penalties.[9] Franchisees have private remedies for state franchise law violations.[10] Besides compensatory damages and, in some states, attorney's fees, an injured franchisee may (1) rescind a franchise agreement for disclosure and registration violations, including fraud in connection with a franchise sale; (2) obtain an injunction to enjoin a wrongful termination or nonrenewal of a franchise; and/or (3) recover damages or restitution.

Furthermore, state franchise laws impose personal, joint, and several liability on the franchisor's management and owners even when the franchisor is a legal entity.[11] Finally, lawyers who overlook franchise laws may be guilty of malpractice and potentially liable to victims of their client's wrongdoing.[12] Because the franchise finding is highly fact-specific, franchise allegations are seldom dismissed early in a case on a motion to dismiss, which significantly adds to the nuisance value of an accidental franchise case, especially when the facts are tenuous to begin with.[13]

## What Is a Franchise?

Most people think they know a franchise when they see one. In fact, franchising is a method of distribution, not a particular industry. There is no uniform definition of a franchise. As consumer protection statutes, franchise laws are given a sweeping scope by courts. Consequently, a broad variety of unsuspecting business arrangements may qualify as franchises.

At the most basic level, a franchise is defined by the coexistence of three elements: (1) a grant of rights to use another's trademark to offer, sell, or distribute goods or services (the "grant" or "trademark" element); (2) significant assistance to, or control over, the grantee's business, which may take the form of a prescribed marketing plan or what some jurisdictions more broadly describe as a "community of interest" (the "marketing plan variation" element; and (3) payment of a required fee (the "franchise fee" element).

A franchise finding hinges entirely on whether an arrangement fits the applicable statutory definition. If any one statutory element is missing, the relationship is not a franchise. The legal analysis considers the parties' actual practices, oral as well as written promises, and course-of-dealing evidence.[14] A party cannot avoid a franchise relationship simply by disclaiming its existence.[15] What the parties call themselves is immaterial.

While federal and state jurisdictions that regulate franchises share common definitional approaches, each jurisdiction has its own definitional subtleties and mix of exclusions and exemptions. What qualifies as a franchise under the federal franchise sales law may not qualify under state law definitions, or vice versa. What is a franchise in one state may not be a franchise in all the regulating states in which the franchisor operates.

Business owners and their advisers are not the only ones confused. Irreconcilable legal precedents reflect misperceptions among regulators and the judiciary about the legal concept of a franchise. As a result, legislators, regulators, judges, and practitioners alike all suffer from uncertainty about the exact kinds of arrangements intended to be regulated as franchises.[16]

In advising companies that manufacture and distribute products or services or that license business methods, technology, patents, or trademarks to independent operators, practitioners should, as a preliminary matter, consider the possibility of unwittingly creating a franchise. In so doing, they should consult the franchise statutes, judicial opinions, and administrative guides of each jurisdiction in which the parties reside or intend to do business before their client offers an opportunity involving an express or implied trademark license or takes steps to modify or end the relationship.

On the federal level, franchises are governed by a Federal Trade Commission rule, which describes both business format and product franchises.[17] Both variations involve the presence of the three basic elements. The business format franchisee adopts the franchisor's business format and identifies its independent operation by the franchisor's trademarks, in exchange for which the franchisee pays the franchisor a fee. The franchisee's operating methods are subject to significant control by the franchisor or, alternatively, the franchisor renders significant assistance to the franchisee in day-to-day operations. Fast food restaurants, convenience stores, and real estate services are examples of business format franchises. The product franchisee distributes goods identified by the franchisor's brand manufactured by, or for, the franchisor. The franchisee pays a fee for the distribution rights above the wholesale price of the goods. As with business format franchises, the franchisor exercises significant control over, or provides significant assistance to, the franchisee. Automobile and gasoline dealerships and delivery route distributors are examples of product franchises.

State law franchise definitions largely resemble the FTC rule's business format and product franchise definitions in that most also require the combination of the three basic elements.[18] The trademark and fee elements are fundamentally the same as the Amended FTC Rule. However, state laws differ by requiring either (1) substantial assistance or control (the federal standard), (2) a marketing plan prescribed in substantial part by the franchisor, or (3) a community of interest. A few state laws define a franchise by a two-prong test that omits either the marketing plan or the payment of a required fee.[19]

## The Trademark Element

The grant of rights to associate with another's trademarks in offering, selling, or distributing goods or services is not only a common element of every franchise definition, but also the easiest definitional element to meet. Absent an express prohibition against use of the licensor's trademark, a right to use the mark will be inferred even if the mark is, in fact, never used.[20] For this reason, every franchise involves an express or implied trademark license of some sort.

Franchise definitions vary from requiring a "license to use" the licensor's mark to requiring a "substantial association" between the grantee's business and the licensor's trademark. Under the "license to use" approach, an express contract authorizing trademark use will support a franchise relationship

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even if the mark is not part of the licensee's trade name—for example, Smith's Appliances, an authorized Brand X Service Center. Permission to display a manufacturer's logo in dealing with customers satisfies this element. Even without explicit contract authority, longstanding use of a licensor's trademark in dealing with customers may be enough to establish a trademark license.

Courts have found a requisite de facto trademark license in the following situations.

- A distributor sold uniquely configured branded goods that consumers readily associated with a particular manufacturer in an exclusive territory.[21]
- A dealer was entitled to identify itself as an authorized dealer of the manufacturer's products in Yellow Pages advertising.[22]
- A distribution agreement imposed a duty to use best efforts to promote the sale of branded products.[23]
- A distributor was required to wear uniforms and add the licensor's logo or name on delivery vehicles or store windows.[24]

States following the "substantial association" approach have also found the requisite trademark element satisfied when branded products or services account for a significant percentage of the independent operator's overall sales.[25]

Many courts have shown a willingness to stretch the definitional elements to achieve desired results. In one California appellate decision, a substantial association with the licensor's mark was found even though the licensee was forbidden to use the licensor's brand name and, in fact, never used it.[26] The court was swayed by evidence showing that a building owner had relied on the licensor's brand name in renting space to the licensee to operate a cafeteria in the building, which was enough to satisfy the substantial association test.[27]

***The Licensor's Quandary***: The fact that an agreement lacks an express trademark license does not prove the trademark element is missing. A de facto license is part of the rights granted to an independent dealer or distributor who is authorized to sell branded products or services accounting for more than an insignificant percentage of the licensee's overall sales. Since the trademark element's presence may depend on the extent of actual branded sales, contract drafting may not save a license from being a franchise. A contract that expressly denies a trademark license may leave the licensor, manufacturer, or supplier with the worst of both worlds: an agreement that is subject to various franchise laws but does not contain the protections that a well-drafted trademark license should contain. The *Gabana Gulf* decision suggests that licensors of branded merchandise may avoid the trademark element by expressly disclaiming any duty to refer customers to the licensee. However, this drafting approach will not work for manufacturers, suppliers, and licensors that view lead generation services or other types of marketing support as vital to their distribution strategy.

## The Marketing Plan Variation Element

A handful of states follow the Amended FTC Rule's approach and require the licensor to furnish significant assistance or impose significant controls over the licensee's entire method of operation. Significant assistance exists when the licensor provides formal sales, repair, or business training programs; site location assistance; management, marketing, or personnel advice; promotional support requiring the licensee's participation or financial contribution; or operating advice such as by furnishing a detailed operating manual. Significant controls exist if the licensor approves or restricts the business location or sales territory, specifies design or appearance requirements, prescribes operating hours, establishes production methods or standards, restricts the customers a licensee may serve, mandates personnel policies or practices, or dictates mandatory accounting practices. Under certain circumstances, any one of these factors may be enough to constitute significant control or assistance. Significant promises of assistance, even if unfulfilled, will satisfy this element. However, merely providing point-of-sale advertising and media support may not be enough.[28]

The franchisee's reliance on the franchisor's experience influences whether the licensor's control or assistance is significant. The franchisee's general business experience, knowledge of the industry, relative financial risk in light of its total business holdings, and the extent to which the controls or assistance go beyond normal industry practices each bears on the reliance factor.

A number of states define a franchise as a trademark license in conjunction with a marketing plan. The marketing plan element is composed of four distinct components, all of which must coexist: (1) a marketing plan (2) prescribed (3) in substantial part (4) by the licensor. Each component has been separately analyzed by judicial and administrative authority.[29]

Determining whether a marketing plan exists is inherently subjective and, consequently, difficult to dodge in a written agreement. While judged by the presence of various facts, no interpretative or judicial opinion suggests a minimum number or combination of facts that inherently guarantee a marketing plan's presence. The parties' contract, course of dealing, and industry customs are all relevant. The term *prescribed* has been interpreted to mean something less than mandatory.[30] Consequently, a marketing plan may be prescribed by implication when it is outlined, suggested, recommended, or otherwise originated by the licensor, even when use of the plan is not obligatory.[31]

Courts differ in the degree of franchisor involvement in a franchisee's daily business activities that are necessary to support a marketing plan. Some require significant control, such as confining sales to assigned territories, imposing sales quotas, establishing mandatory sales training, or supplying detailed instructions for customer selection and solicitation. Other courts have found a marketing plan based on far less—for example, a promoter's recommendations, advice, or suggestions even when there is no obligation on the franchisee's part to observe them, such as suggesting resale prices and discounts, providing demonstration equipment or advertising materials, recommending or screening advertising materials, or providing product catalogs.

What courts identify as a "marketing plan prescribed in substantial part" may actually be basic to most distributorships.[32] For example, a marketing plan was found to exist when

- dealers were required to advertise the manufacturer's products intensively, conduct a variety of promotions, and carry the manufacturer's array of accessory sales devices;[33]

- distributors marketed products pursuant to a comprehensive advertising and promotional program developed by the supplier, who reserved the right to screen and approve all promotional materials used by distributors;[34]
- distributors were required to perform warranty services in accordance with the manufacturer's warranty policy, send representatives to sales meetings, complete the manufacturer's factory service training program, maintain minimum inventory levels, hire an extra salesman, and provide periodic sales reports to the manufacturer;[35]
- a promoter promised to provide a marketing plan even though it failed to deliver on its promise.[36]

Administrative and judicial opinions try to forge a distinction between production-type controls, which do not result in a marketing plan, and marketing controls, which do, but the distinction between the two has never been well articulated.[37] A marketing plan can exist even when the controls or advice do not relate to advertising or marketing matters, such as when a manufacturer provides detailed instructions and advice regarding operating techniques and skill training that make independent businesses appear as if they are centrally managed and follow uniform standards.

Several states follow the community of interest model, rather than the marketing plan or assistance/control approach, but differ in how they define this element. However, all these states agree that a community of interest exists when parties derive fees from a common source—a standard that potentially encompasses every distributorship and license.[38]

***The Licensor's Quandary***: Because the trademark element of a franchise is so easily established, trademark licensors may be tempted to avoid a franchise finding by eliminating the second definitional element—some form of assistance to or control over the licensee's business. This creates a dilemma because the federal Lanham Act imposes an affirmative duty on licensors to control the quality and uniformity of goods and services associated with their federally registered trademarks. Failure to do so may result in abandonment of trademark rights. As a practical matter, it is often impossible to distinguish trademark quality controls from the factors identifying substantial control, a marketing plan, or a community of interest. It may also be inadvisable to try to avoid franchise laws by eliminating or modifying contractual provisions designed to protect product or service quality or set operating standards that identify the licensee with a larger branded network. A licensor that eliminates or reduces quality controls may not only sacrifice important core values vital to the business and brand—it may risk abandoning its trademark rights.

## The Required Fee Element

The required fee element captures all sources of revenue paid by a franchisee to a franchisor for the distribution rights or license. The element is deliberately expansive, encompassing lump-sum, installment, fixed, fluctuating, up-front, and periodic payments for goods or services, however denominated, whether direct, indirect, hidden, or refundable.[39]

Under federal law, imputation of a franchise relationship can be avoided by deferring required payments over $500 for at least six months after the licensee or distributor begins operations. The federal franchise definition requires the franchisee to make a minimum payment of at least $500 within that time frame.[40] A license will not be deemed a franchise under federal law even if the licensee signs a nonnegotiable, secured promissory note (with no acceleration clause) promising to pay the licensor $500 or more after six months. While this exemption offers interesting structuring opportunities for franchises sold in states without franchise laws, it has no counterpart in most states with franchise laws. Deferral of fees, therefore, is not a universal solution for avoiding franchise status.

All jurisdictions exclude payments that do not exceed the bona fide wholesale price of inventory if there is no accompanying obligation to purchase excessive quantities. To qualify, the payment must be entirely for *goods* for which there is a ready market.[41] Most product distribution arrangements rely on the bona fide wholesale price exclusion in structuring nonfranchise distributorship or dealership programs.

For the fee element, only required payments count, not optional ones. Nevertheless, calling something optional is not necessarily controlling. Payments, though nominally optional, will be deemed required if they are essential for the successful operation of the business.[42]

Finally, to be classified as a required fee, the payment must be made to the licensor or its affiliate or for their benefit as the quid pro quo for the licensing or distribution rights. For this reason, commissions paid by a licensor to a licensee are not franchise fees because no money flows to the licensor.[43] If, by arrangement, a licensee is required to discharge the licensor's debt to a third party, or a third party remits a portion of the licensee's payments to the licensor, an indirect franchise fee exists.

There remains lingering confusion about whether and when ordinary business expenses paid to third parties to establish or maintain a business qualify as a required fee. All jurisdictions that have considered the issue, except Indiana, have held that franchise fees are confined to payments to the franchisor (or an affiliate, or for the benefit of either) and exclude payments to third parties.[44]

Nevertheless, confusion persists over when required payments *to a licensor* are merely ordinary business expenses and not for the licensing or distribution rights. For example, advertising fees paid to a licensor are commonly classified as franchise fees.[45] However, a decision under the Minnesota Franchise Act found advertising fees paid to a supplier to be ordinary business expenses where (1) the fee was not based on the retailer's gross or net sales, but on the amount of inventory purchased from the supplier; (2) the supplier derived no income or profit from the advertising fee and supposedly took nothing out of the advertising fund to cover its administrative costs; and (3) the supplier kept the fees in a segregated account and did not commingle them with its own operating revenues.[46] Co-op advertising fees common to beverage and other distribution programs—where the supplier matches the distributor's contribution and spends the funds entirely to promote the brand—have also been found to be ordinary business expenses when the distributor is free to opt out of participating in the supplier's marketing programs.[47]

At the same time, payments to a licensor for equipment and other items that may be purchased, and are readily available, from other sources should not be classified as franchise fees simply because the licensee chooses to buy the items from the licensor and not shop elsewhere.[48]

While a franchise fee—direct or indirect—is generally a prerequisite for application of federal and state franchise *sales* laws, it is not a prerequisite for the application of several *relationship* laws regulating termination, nonrenewal, and other substantive conditions of the parties' relationship.[49] As noted, a handful of state franchise and dealer relationship laws regulate arrangements defined by a two-prong test that omits the required fee element.

***The Licensor's Quandary***: For the trademark licensor trying to avoid a de facto franchise agreement, the fee element is the easiest of the three definitional prongs to avoid. A manufacturer or supplier of branded goods that limits its compensation from a distributorship or dealership to the difference (markup) between its cost of goods and the bona fide wholesale price at which it sells the goods to distributors or dealers can lawfully avoid the franchise laws in all jurisdictions that use a three-prong definition. This is true regardless of how closely the licensor, manufacturer, or supplier controls the distribution process or how much the supplier's markup is.[50]

Often a trademark owner is in a position to collect a premium from those who want to affiliate with its brand. A manufacturer or supplier may impose innocuous payments for noninventory materials or support services, like sales manuals, demonstration kits, point-of-sale materials, or bookkeeping services, not suspecting that these payments may be enough to constitute a franchise fee.

Some branded affiliations do not involve the purchase of inventory, like service businesses and technology alliances. In these relationships, the bona fide wholesale price exception is not available, and all payments that flow from the licensee to the licensor are potentially franchise fees.

Frequently, licensors, manufacturers, and suppliers do not awake to the reality of the franchise relationship until years after it is formed when they seek to end the relationship pursuant to an at-will termination provision in their contract. Franchise relationship laws prevent the licensor from ending the relationship unless the licensee is in material breach, the essential basis of good cause. Because franchise laws cannot be waived, once a fee is paid anytime during the parties' affiliation, a licensor may find itself foreclosed from reverting to nonfranchise status even if the licensor offers to refund the unintended franchise fee.[51] The dilemma for the trademark licensor is that, in order to escape franchise regulation, it may be required to leave dollars on the table.

Every U.S. jurisdiction regulating franchises has its own mix of definitional exclusions and exemptions, offering a complicated and often confusing maze of structuring opportunities and limitations for companies considering regional or national expansion. Some exclusions and exemptions are common to most, or all, jurisdictions[52] while others are unique to a particular jurisdiction.[53]

Accordingly, individual statutes must always be checked. For example, the Amended FTC Rule and some, but not all, regulating states exclude or exempt arrangements referred to as *fractional franchises* in which less than 20 percent of the licensee's revenue is derived from sales of the licensed brand.

### Accidental Franchises

Because branding is increasingly important in consumer purchasing decisions, accidental franchises occur more frequently today than when franchise laws were first enacted in the 1970s. Accidental franchises occur because franchise laws poorly articulate the distinction between nonfranchise and franchise licenses.

Every branded distribution arrangement involves an implied, if not an express, trademark license. Strategic affiliations between brand owners, with each owner giving the other the right to affiliate publicly with the other's brand, are, at a minimum, de facto licenses. With few exceptions, the brand owner's equity stake in a joint venture will not save the joint enterprise—a distinct legal entity—from being classified as a franchisee.

Each time a license, distributorship, strategic trademark alliance, or other type of branded joint venture or marketing affiliation is formed, the cornerstone of a franchise potentially is laid. Given the prevalence of technology-related licenses and co-branding programs today, that cornerstone may be laid more often than brand owners realize.

Courts have shown no sympathy for trademark owners that defend franchise claims by pleading ignorance of the law or no intent to create a franchise.[54] Modeled after U.S. security laws, franchise statutes impose strict liability, thereby making a defendant's intent or knowledge of the law irrelevant.[55] Franchise laws have their roots in consumer protection legislation, and, as a consequence, are construed liberally.

Given the serious consequences flowing from an accidental franchise, lawyers should suspect a franchise whenever an express or de facto trademark license presents itself. Strategic branding alliances, joint ventures, sales agencies, distribution cooperatives, and technology licenses should all be viewed suspiciously as hidden franchises and closely inspected to see if money is being paid, directly or indirectly, by one party for the right to associate with the other's trademarks.

Certain aspects of the franchise definition, like the marketing plan, community of interest, and substantial assistance and control elements, are so inherently imprecise that it is difficult to render an opinion to a client that an arrangement does not contain at least some indicia of a franchise. The key is knowing how many factors are enough to tip the scale.

Counsel should never rely on contract terminology or disclaimers, neither of which will defeat deemed franchise status. Yet contract drafters are not without tools. A license or distribution contract deliberately structured to avoid a franchise definitional element or take advantage of a statutory exemption or exclusion should express these facts in the contract. While self-serving and certainly not bulletproof, the plain language will aid, and possibly influence, the fact-finder's analysis of the franchise claim.

Structural solutions may save some relationships from the reach of franchise laws but often come at the price of sacrificing essential economic objectives or competitive opportunities.

The regulatory burdens of being deemed a franchisor should be kept in perspective. Numerous companies comply with federal and state franchise laws and sustain and grow successful, viable businesses. They compete in the marketplace while complying with presale disclosure and annual registration duties, close franchise sales while honoring rules restricting promises about future earnings, and manage franchise relationships while respecting laws requiring good cause for termination or nonrenewal.

In the long run, the costs associated with franchise avoidance, be they added business risks or extra legal expenses, may be more painful than franchise law compliance. Companies are short-sighted if their overwhelming desire to avoid legal regulation as a franchise drives their business decisions and strategic objectives.[56] ■

## Endnotes

1. 60 Cal. App. 4th 1294 (1998).

2. 397 F. Supp. 357 (D. Conn. 2005).

3. Chartschlaa v. Nationwide Mut. Ins. Co., 538 F.3d 116 (2d Cir. 2008). The Second Circuit found that the agent abandoned its franchise claim when it deliberately failed to schedule the agency agreement as an asset in filing for Chapter 7 bankruptcy years earlier. This spared the court from addressing the substantive issue of whether an insurance agency is a franchise under Connecticut law.

4. Unlike other industries, insurance groups did not participate in public hearings in the 1970s on the original FTC Franchise Rule. Back then, the insurance industry probably assumed it had no connection to franchising. Since then, at least a dozen reported decisions under different state franchise laws have considered whether an insurance agency is a franchise. While *Charts* is the only reported decision to rule for the agent, insurance companies continue to face the prospect of franchise claims. *See*, *e.g*., Bucciarelli v. Nationwide Mut. Ins. Co., 2009 U.S. Dist. LEXIS 30181 (E.D. Mich. 2009) (franchise claim not dismissed, but court expressed skepticism that the agent could prove it had paid a franchise fee under Michigan's franchise law).

5. 2006 U.S. Dist. LEXIS 59799 (N.D. Cal. 2006), summary judgment granted to defendant in 2008 U.S. Dist. LEXIS 1658 (N.D. Cal. Jan. 9, 2008), *aff'd*, 2009 U.S. App. LEXIS 18996 (9th Cir. 2009) ("*Gabana Gulf*"). In 2006, the court refused to dismiss the franchise claim; in 2008, the court tossed out the franchise claim on summary judgment; and in 2009, summary judgment was affirmed. The three-year ordeal illustrates the nuisance cost of an accidental franchise claim.

6. 549 F.3d 1079 (7th Cir. 2008).

7. Some franchise statutes specifically limit their application to "continuing commercial arrangements" and do not apply to not-for-profit arrangements. The Wisconsin statute addressed in *Girl Scouts of Manitou Council* makes no distinction between "for-profit" and "not-for-profit" arrangements. *Id.* at 1092.

8. The Amended FTC Rule requires presale disclosure, but there is no duty to register with a federal agency. California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin have franchise sales laws coupled with some obligation on franchisors to register the franchise offer with a state agency. The Amended FTC Rule supplements state franchise sales laws but does not preempt them. Roughly half the states also have some type of relationship law protecting franchisees against termination or cancelation of the franchise without good cause.

9. See, for example, 2009 California enforcement actions against Play N Trade and Yakety Yak Wireless for multiple statutory violations (http://www.corp.ca.gov/ENF/list/y/YaketyYak.asp), and *Federal Trade Commission v. Prophet 3H, Inc*., FTC No. 062-3050, Case No. 06-CV-1692, Trade Reg. Rep. (CCH) ¶ 16,093 (N.D. Ga. 2007) (multimillion-dollar penalties assessed against organizers of health care business venture for FTC Rule violations).

10. There is no private right of action for violations of the Amended FTC Rule, which only the FTC may enforce. Private parties may have remedies under state unfair trade laws based on Amended FTC Rule violations.

11. Spahn v. Guild Indus. Corp., 94 Cal. App. 3d 143 (1979).

12. *See* Alexander M. Meiklejohn, *UFOCs and Common Law Claims Against Franchise Counsel for Negligence*, 25 Franchise L.J. 45 (Fall 2005).

13. *See*, *e.g*., Coyne's & Co. v. Enesco, LLC, 565 F. Supp. 2d 1027, 1049 (D. Minn. 2008) (claim that payment was an indirect franchise fee under Minnesota franchise law required fact-specific inquiry not appropriate on motion to dismiss); Budner v. Wellness Int'l Network, Ltd., 2007 U.S. Dist. LEXIS 18256, at *37 (N.D. Tex. 2007) (Illinois's sweeping franchise definition prevented early dismissal of franchise law claim).

14. The Amended FTC Rule excludes purely oral agreements from its franchise definition, but most state franchise definitions apply to both oral and written contracts.

15. People v. Kline, 110 Cal. App. 3d 587 (1980) (partnership agreement held to be franchise).

16. Stephen C. Root, *The Meaning of "Franchise" Under the California Franchise Investment Law: A Definition in Search of a Concept*, 30 McGeorge L. Rev. 1163, 1188 (1999). Sales agencies and employment arrangements may qualify as franchises. *See* John R. F. Baer & Scott P. Weber, *When Are Sales Representatives Also Franchisees?* 27 Franchise L.J. 151 (Winter 2008); Dean T. Fournaris, *The Inadvertent Employer: Legal and Business Risks of Employment Determinations to Franchise Systems*, 27 Franchise L.J. 224 (Spring 2008).

17. Federal Trade Commission, Compliance Guides, 72 Fed. Reg. 15444 (Mar. 30, 2007). Originally, the FTC Rule applied to a third type of franchise, business opportunity ventures, akin to franchises, but without the trademark element (e.g., vending machine routes and work-at-home programs). The FTC now regulates business opportunities in a separate rule, 16 C.F.R. Part 437.

18. California's franchise definition, a three-prong definition, expresses the right to offer, sell, *or* distribute goods or services in the disjunctive, making it broader than some other three-prong definitions. Gentis v. Safeguard Bus. Sys., 60 Cal. App. 4th 1294, 1300 n.1 (1998) ("By using the word 'or,' the Legislature intentionally broadened the scope of the statute.").

19. Arkansas, Connecticut, Delaware, Missouri, Nebraska, New Jersey, Wisconsin, Puerto Rico, and the U.S. Virgin Islands have relationship laws that define the protected relationship without reference to payment of a required fee. Two-prong definitions potentially sweep a far broader range of business arrangements than three-prong statutes.

20. The California Department of Corporations, which enforces California's Franchise Investment Law, elaborates on California's franchise definition in Release 3-F, When Does an Agreement Constitute a "Franchise"? (rev. June 22, 1994), *available at* http://www.corp.ca.gov/commiss/rel3f.htm [hereinafter Release 3-F]. Regarding the trademark grant, it says: "[i]f a franchisee is granted the right to use the franchisor's symbol, that part of the franchise definition is satisfied even if the franchisee is not obligated to display the symbol." Release 3-F has been cited favorably by other courts and franchise agencies in interpreting other franchise laws.

21. Lobdell v. Sugar 'N Spice, 658 P.2d 1267 (Wash. Ct. App. 1983).

22. Am. Bus. Interiors, Inc. v. Haworth, Inc., 798 F.2d 1135 (8th Cir. 1986).

23. Cassidy Podell Lynch, Inc. v. Snyder Gen. Corp., 944 F.2d 1131, 1139 (3d Cir. 1991).

24. Cooper Distrib. Co., Inc. v. Amana Refrigeration, Inc., 63 F. 3d 262, 272–73 (3d Cir. 1995).

25. States do not construe "substantial association" uniformly. There is no universally recognized *minimum* percentage of branded product sales that qualifies as a "substantial association" with a supplier's trademark. The Amended FTC Rule and a number of state laws exempt "fractional franchises" from regulation, generally defined as multiline distributorships where sales of any one brand make up less than 20% of the distributor's total sales. However, "substantial association" has been found based on less than 20% branded sales.

26. Kim v. Servosnax, Inc., 10 Cal. App. 4th 1346 (1992).

27. *Gabana Gulf* found the trademark element missing from the Gap-Gabana relationship and distinguished *Kim v. Servosnax.* According to the court, Gap did nothing to lead Gabana's customers to Gabana, unlike the building owners who had selected Servosnax to set up a branded cafeteria and install an operator to run it. The distinction seems thin: Gabana had exclusive distribution rights to the Middle East so any retailer in the region who wanted to sell Gap brand merchandise did not need Gap's help to direct them to Gabana. In affirming *Gabana Gulf*, the Ninth Circuit relied on *Hoosier Penn Oil Co. v. Ashland Oil Co.*, 934 F.2d 882 (7th Cir. 1991), which rejected a

Valvoline distributor's argument that merely selling a branded product creates a substantial association with that trademark.

28. Release 3-F, *supra* note 20.

29. *Id.* Release 3-F explains the components of the marketing plan element and identifies numerous factors indicating a marketing plan.

30. *Id*.

31. *Id*.

32. Steven D. Wiener, Gentis v. Safeguard Business Systems, Inc., *Liberal Construction of Remedial Statutes: What Is a Franchise?* 17:4 FRANCHISE L.J. 115 (1998).

33. Boat & Motor Mart v. Sea Ray Boats, Inc., 825 F. 2d 1285 (9th Cir. 1987).

34. Meadow Fresh Farms, Inc. v. Sandstrom, 333 N.W.2d 780 (N.D. 1983).

35. Carlos v. Philips Bus. Sys., Inc., 556 F. Supp. 769 (E.D.N.Y. 1983), *aff'd in part and rev'd in part*, 744 F.2d 287 (2d Cir. 1984).

36. People v. Kline, 110 Cal. App. 3d 587 (1980).

37. Whether know-how controls, common to patent licenses, are enough to turn a nonfranchise license into a franchise depends on whether the know-how affects just an aspect of the licensee's operations (e.g., production) or is more pervasive.

38. *See*, *e.g*., Instructional Sys., Inc. v. Computer Curriculum Corp., 826 F. Supp. 831 (D.N.J. 1993).

39. Amended FTC Rule, § 436.2(a)(2); Release 3-F, *supra* note 20. Fees may be bundled and therefore buried in charges for goods or services. *See* Lobdell v. Sugar 'n Spice, 658 P.2d 1267, 33 Wash. App. 881, 892 (Wash. Ct. App. 1983). *See generally* Jonathan Solish, *Unrecoverable Investments Are Critical*, 26 FRANCHISE L.J. 1 (2006); Bruce Napell, *State Relationship Laws Are Not Uniform*, 26 FRANCHISE L.J. 1 (2006).

40. Amended FTC Rule, § 436.2(a)(3)(iii).

41. Boat & Motor Mart v. Sea Ray Boats, Inc., 825 F.2d 1285 (9th Cir. 1987).

42. Release 3-F, *supra* note 20.

43. *Thueson v. U-Haul International, Inc.*, 2006 Cal. App. LEXIS 1736, at *12 (2006), was the first California court decision to explain what constitutes a franchise fee under California's franchise law. Unfortunately, the discussion was unnecessary to the court's holding. Following *Wright-Moore Corp. v. Ricoh Corp.*, 908 F.2d 128 (7th Cir. 1990) (Indiana law), *Thueson* clarified that a franchise fee requires a "firm-specific investment in the franchisor" in contrast to payments for ordinary business expenses. However, *Thueson* shed no light on when a payment to a licensor is, and is not, a firm-specific investment. Moreover, the facts showed the U-Haul dealer made no payments at all to U-Haul. Rather, U-Haul deducted from the dealer's rental commissions expenses for the dealer's use of a local telephone line, directory listing, and local computer terminal. The idea that commission deductions are not franchise fees is in line with previous interpretations of California law. *See* Adees Corp. v. Avis Rent a Car Sys., 157 Fed. App'x 2 (9th Cir. 2005).

44. *See*, *e.g*., *Wright-Moore Corp.*, 908 F. 2d 128.

45. Release 3-F, *supra* note 20.

46. R&A Small Engine, Inc. v. Midwest Stihl, Inc., 2006 U.S. Dist. LEXIS 92208 (D. Minn. 2006). The Minnesota decision seem at odds with precedent in other jurisdictions and offers no bright line for distinguishing when payments to a licensor are ordinary business expenses and not for the right to use the licensor's marks.

47. *Day Distributing Co. v. Nantucket Allserve, Inc.*, 2008 U.S. Dist. LEXIS 57334 (D. Minn. 2008) (Minnesota law), relied on *Midwest Stihl*. In turn, *JJCO, Inc. v. Isuzu Motors America, Inc*., 2009 U.S. Dist. LEXIS 47128 (D. Haw. 2009) (Hawaii law), relied on *Day Distributing*. *JJCO* ruled that marketing fees that an Isuzu dealer was required to pay to cover its share of Isuzu's advertising costs were ordinary business expenses and not a franchise fee. *JJCO* failed to note that the marketing program in *Day Distributing* was optional, so the distributor's marketing fees were optional, not required.

48. See, for example, Reg. 200.105 to the Illinois Franchise Disclosure Act, 815 ILL. COMP. STAT. 705/1-44 (1999), excluding payments for items that the franchisor permits the franchisee to buy from third parties and that are readily available elsewhere. *See also* Hamade v. Sunoco, Inc., 271 Mich. App. 145, 163–64 (Mich. Ct. App. 2006) (franchise fee requires a transfer of wealth; loan repayment was not a franchise fee absent proof of above-market interest rate).

49. *See supra* note 19.

50. Sports Racing Servs. v. Sports Car Club of Am., 131 F.3d 874, 891 (10th Cir. 1997) (Indiana law). Whether a markup above a bona fide wholesale price is an indirect franchise fee requires a fact-specific inquiry. *See* Coyne's & Co. v. Enesco, LLC, 553 F.3d 1128, 1132 (8th Cir. 2009) (35–50% markup over manufacturer's cost of goods was not an indirect franchise fee under Minnesota franchise law); Kenaya Wireless v. SSMJ, 2009 Mich. App. LEXIS 692 (Mich. Ct. App. 2009) (markup to cover supplier's shipping and overhead costs did not prevent bona fide wholesale price finding).

51. A franchise fee includes payments for the right to enter a business that are made during the course of the business, not just at inception. In *To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift America, Inc.*, 152 F.3d 658, 659–60 (7th Cir. 1998), the Seventh Circuit found that a tractor dealership, which was not a franchise at the inception of the parties' relationship, became one when the dealer's incremental payments for sales manuals over the course of eight years exceeded $500, Illinois's statutory threshold at the time. The idea that a nonfranchise relationship could turn into a franchise sometime after the parties execute a contract adds uncertainty to the status of licensing and distribution arrangements.

52. For example, transfers by franchisees are not regulated by federal or state franchise sales laws if the buyer assumes the seller's contracts and the licensor's involvement is confined to approving the buyer's qualifications.

53. For example, Minnesota exempts burglar alarm franchises and arrangements between local and national airline carriers.

54. *To-Am*, 152 F.3d at 659–60. The Seventh Circuit admonished inadvertent franchisors everywhere: "Legal terms often have specialized meanings that can surprise even a sophisticated party. The term 'franchise,' or its derivative 'franchisee,' is one of those words."

55. Keating v. Superior Court, 31 Cal. 3d 584, 597 (1982).

56. This article is based in part on *Franchise Player,* an article written by the author for LOS ANGELES LAWYER in December 2006.