# Accidental Franchises – What You Don't Know Can Hurt Your Client

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Why should all business attorneys be concerned about franchise laws? Businesspeople and attorneys often are unaware that franchise laws impact a variety of business relationships. Under federal law, as well as in California, it does not matter whether you call a business arrangement a "partnership," a "license," a "dealership," a "joint venture" or something else when you draft the agreement, or whether the agreement disclaims the existence of a franchise; if the elements of a franchise are present, it is a franchise. Knowing the following basics can help you identify franchise arrangements and prevent your business clients from becoming accidental franchisors, or from inadvertently contracting with an accidental franchisor.

### *What is a Franchise Under California Law?*

Under California law, a business relationship is a "franchise" if: (1) the business will be substantially associated with the franchisor's trademark; (2) the franchisee will directly or indirectly pay a fee to the franchisor for the right to engage in the business and use the franchisor's trademark; and (3) the franchisee will operate the business under a marketing plan or system prescribed in substantial part by the franchisor.

If a business uses another company's trademark to identify itself it can be argued that the business is "substantially associated" with the franchisor's trademark. Courts have broadly interpreted the "substantial associated" element. *See, for example Kim v. ServoSnax*, 10 C.A.4th 1346 (1992) (holding that the trademark element was satisfied in a licensing arrangement even though the licensor's trademark was not communicated to the public or to customers).

The "fee" element is also easily satisfied. Just about any payment to the licensor or its affiliate for licensing or distribution rights can fulfill the "fee" element. However, payments that do not exceed the bona fide wholesale price of inventory are excluded from the definition of a franchise fee, if there is no accompanying obligation to purchase excessive quantities. Further, ordinary business expenses are not franchise fees.

The third element, which requires that the franchisee operate the business under a marketing plan or system prescribed in substantial part by the franchisor, is known as the "control" element. The "control" element is so broadly interpreted that the mere promise of assistance, even if unfilled, will satisfy this element.

If the three elements of a franchise exist, then the relationship is a franchise, no matter what the parties call it.

### *Risks of Mischaracterizing the Business Relationship*

California courts have little compassion for trademark owners that claim they did not know the law or argue that there was no intent to create a franchise. *See, for example Boat & Motor Mart v. Sea Ray Boats*, 825 F.2d 1285 (9th Cir. 1987) (finding that a dealership agreement between a boat dealership and the manufacturer was a franchise despite the manufacturer's argument that it did not prescribe a marketing plan to its dealers).

The California Department of Business Oversight (DBO) monitors franchisor-franchisee arrangements and may assess penalties of $2,500 per violation of the California Franchise Investment Law. The DBO also has the authority to require franchisors to provide its franchisees with written notice of the violation, offer rescission of the franchise, and refund payments made by the rescinding franchisees.

Attorneys representing business owners must be able to spot the telltale signs of a franchise, or a potential franchise, to avoid unwittingly assisting their clients in becoming

*Continued on page 19*

Kurtz and Wallman, *continued from page 17*

accidental franchisors, as well as inadvertently contracting with accidental franchisors.

## *Understanding the Differences between Franchises and Other Business Arrangements*

*Licensing, Distributorships, and Dealerships.* Licensing, distributorship, and dealership arrangements are not franchises because they are missing at least one of the three elements of a franchise. Under a typical licensing arrangement, one company licenses another to sell its products or services in exchange for a specified amount of the proceeds without any additional involvement of the licensor. However, if the licensor provides additional support, such as training or promotional assistance that constitutes a sufficient amount of control, the licensor has become a franchisor.

In dealership and distributorship arrangements, independent businesses operate under their own trade names and usually buy products or services from another party at wholesale prices and then resell them to the public. Generally, distributorship arrangements do not constitute franchises because the definition of a "fee" is not met. A "fee" does not include payment for the purchase of initial and ongoing inventory at bona fide wholesale prices. If the distributor begins to sell items not intended for resale, such as displays, sales kits, or advertising, the "fee" element may be triggered. Further, marketing and training assistance could trigger the "control" element and inadvertently turn the relationship into a franchise.

## *Franchises Require Pre-Sale and Ongoing Legal Compliance*

*Franchise Registration.* Non-franchise trademark licenses are private contracts. Licensors do not have to make public disclosure about their financial condition or other sensitive business information. Franchising, however, is a highly regulated industry. Under California's Franchise Investment Law, it is unlawful to offer or sell a "franchise" in California unless the offering has been registered with the DBO or it is exempt from registration. If a business relationship satisfies the elements of a franchise under California law, the franchisor must: (1) file a franchise disclosure document with the DBO outlining the franchise opportunity in detail and providing information regarding the franchisor's own background and business experience before entering into any discussions with potential franchisees; (2) disclose potential franchisees with its registered disclosure document and wait at least 14 full days before having the franchisee execute any franchise documents or accepting any payments; and, (3) obtain DBO approval for any "material modifications" to its registered franchise documents before presenting them to franchisees. These burdens are not imposed in licensing, distributorship and dealership relationships.

*Franchise Relationship Laws.* The regulation of a franchise relationship does not end once the franchise disclosure document is registered and the franchise agreement is signed. Twenty-four states, including California, have enacted franchise relationship laws that aim to limit franchisor abuses of the franchise relationship. These laws regulate what the franchisor can contractually do under the franchise agreement, including enforcement of system standards, renewal, and termination of franchise rights and noncompetition covenants. These relationship laws will apply throughout the life span of the franchise.

## *Why Franchise?*

Franchising can be a highly effective expansion strategy. Creating a franchise system allows franchisors to expand already successful business concepts, achieve greater brand recognition, and diversify risk through the investments of its franchisees. Franchisees enjoy many notable benefits from the franchisor-franchisee relationship, including access to a proven business system, a wider customer base, greater brand name recognition, and a stronger market presence; group purchasing discounts, professional marketing, research and development benefits; continuing education and training; and support from their franchisor and other franchisees with similar goals, needs, and challenges.

## *Wrap-up*

The determination of whether a license, distribution or dealership arrangement should be treated as a franchise must be made after a thorough analysis of your client's business structure. Understanding the basics of franchising will allow you to better advise your clients and, when necessary, will help you recognize when it is time to contact a franchise law specialist to assist you and your client through a potential minefield of unintended consequences. ■

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