By Barry Kurtz and Katherine L. Wallman

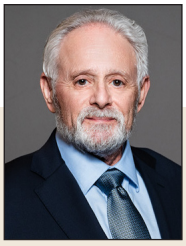
Unintentional Franchises

ALL BUSINESS ATTORNEYS SHOULD BE concerned about franchise laws. Unsuspecting businessowners and attorneys often are unaware that a simple license agreement drafted for a business could actually be a franchise agreement.

Under federal law, as well as in California, if the elements of a franchise are present, a business arrangement is a franchise, regardless of whether it is called a "partnership," a "license," a "dealership," a "joint venture" or something else, or whether the agreement disclaims the existence of a franchise. Business attorneys with clients eager to speed into brand expansion should know the fundamental principles of franchise law to help determine whether a business relationship is actually an arrangement other than a franchise to prevent business clients from becoming unintentional franchisors, or from inadvertently contracting with an unintentional franchisor. Without a basic understanding of franchise law, you may miss the warning signs that the proposed business arrangement may create a franchise.

Why Franchise?

Franchising can be a highly effective expansion strategy. Creating a franchise system allows franchisors to expand already successful business concepts without taking on substantial debt, achieve greater brand recognition, and diversify risk through the investments of its franchisees. Franchisees are also strongly incentivized to achieve high performance and innovation as their personal financial success is intrinsically tied to the success of their franchised outlets. Franchisees enjoy many 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



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development benefits; continuing education and training; and support from their franchisor and other franchisees with similar goals, needs, and challenges.

What is a Franchise Under Federal and California Law?

The Federal Trade Commission ("FTC") defines a "franchise" in the FTC Franchise Rule ("FTC Rule") as any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:

- The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;
- The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and
- As a condition of obtaining or commencing operation of the franchise, the franchisee makes a requirement payment or commits to make a required payment to the franchisor or its affiliate.

Under the California Franchise Investment Law ("CFIL"), a business relationship is a "franchise" if: (i) the business will be substantially associated with the franchisor's trademark; (ii) 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 (iii) the franchisee will operate the business under a marketing plan or system prescribed in substantial part by the franchisor.

The definition of a franchise under the laws of other registration-required states are similar to definitions in the FTC Rule and the CFIL. These state definitions call for the payment of an initial or ongoing fee (or both) by the franchisee for the use of the franchisor's system and trademarks, a substantial association of the franchised business with the franchisor's trademarks and presence of the "control" element.

The California Department of Financial Protections and Innovation ("DFPI") regulates franchise sales in California, and interprets the three elements of a franchise broadly, generally in favor of a putative franchisee. If a business uses another company's trademark to identify its business, or in its advertising, it can be argued that the business is "substantially associated" with the other company's trademark. Courts have liberally interpreted the "substantial associated" element. The wide scope of the trademark association element is illustrated by *Kim v. ServoSnax*, 10 C.A.4th 1346 (1992), where a California appellate court found the trademark element was satisfied even though the operator was prohibited from using the licensor's trademark. Despite the explicit prohibition against use of a licensor's trademark, the court found the business was substantially associated with the licensor's trademark because the licensor's brand name was important to a third-party facility owner in deciding whether to permit an operator to operate its business on their premises.

The "fee" element is also easily satisfied. Just about any payment to the licensor or its affiliate for licensing or distribution rights paid to enter into the franchised business can fulfill the "fee" element, regardless of the designation given to, or the form of, such payment.

Certain types of payments are excluded from the definition of a "franchise fee," such as payments to the franchisor or its affiliates that are "optional." However, payments, though nominally optional, will be deemed required, and therefore a "franchise fee," if they are essential for the successful operation of the business. Further, 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. Under these circumstances, such a payment is not deemed to be made for the right to enter into the franchised business. This exception is based on the rationale that no substantial prejudice will come to a purchaser buying a business and paying only the bona fide wholesale price for merchandise that they propose to resell in that business, since they can readily turn goods of established value into cash, should the seller fail, in any way, to provide the promised support. The bona fide wholesale price means the price at which goods are purchased and sold by a manufacturer or wholesaler to a wholesaler or dealer where there is ultimately an open and public market for sales of the goods to consumers of the goods.

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

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as the "control" element. A marketing plan will likely exist when a licensee must comply with the licensor's directions or obtain the licensor's approval on significant elements of the licensee's business, such as the selection of locations and the use of trade names, advertising, signs, sources of supply, fixtures and equipment, menu offerings, recipes, employee uniforms, hours of operation, and similar requirements at the licensee's business premises. The "control" element is so broadly interpreted that the mere promise of assistance, even if unfilled, or the option to use certain services, even if not exercised, will satisfy this element. Further, a marketing plan may be deemed to exist merely on the basis of controls designed to protect a licensor's ownership rights in a trademark or service mark.

If the three elements of a franchise exist, then the relationship is a franchise, no matter what the parties call it. As discussed below, if it is a franchise, the franchisor needs to have an FDD and register the FDD in California. Twelve additional states have similar franchise laws, which require pre-sale registration of the FDD: Hawaii, Washington, North Dakota, South Dakota, Wisconsin, Minnesota, Illinois, Indiana, New York, Rhode Island, Maryland and Virginia. The remaining 37 states without their own franchise laws are governed by the FTC Rule, which requires disclosure with an FDD but have no registration requirements.

Failure to have an FDD or register the FDD with the DFPI violates the CFIL (Corp. Code Sec. 31110) and entitles the franchise buyer to damages and in some cases rescission of the franchise agreement (Corp. Code Sec. 31300).

Risks of Mischaracterizing the Business Relationship

California courts have little sympathy 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). Seemingly simple arrangements for the sale of goods or services identified by the licensor's trademark often form a franchise, despite the parties' lack of intent to be in a franchise relationship. These situations frequently arise and force unsuspecting licensors to defend against franchise law allegations.

For licensors that later decide to franchise their concept with an FDD and registration, the DFPI is likely to withhold registration unless and until the licensor gives written notice of the violation to current operators and offers rescission of all agreements with them, and discloses to prospective franchisees its previous noncompliance with franchise laws. The DFPI may assess penalties of $2,500 per violation of the CFIL without a showing that the violation was willful. The DFPI 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. The franchisor will also need to disclose these violations in their future FDDs, in some cases for up to 10 years, which can negatively impact future franchise sales.

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Unknowingly entering into a franchise arrangement also creates unexpected risks for a franchisor's officers and salespeople. Any person who offers or sells a franchise in violation of the registration requirements is liable to the franchisee for damages. *See Avcar v. Dollar System Rent-a-Car* 890 F.2d 165 (9th Cir. 1989). There are also civil and criminal sanctions, including possible felony prosecution. Corps. Code Sec. 31410; *People v. Gonda*, 138 C.A.3d 775 (1982); *People v. Kline*, 110 C.A.3d 597 (1982).

Attorneys representing business owners must be able to spot the signs of a franchise, or a potential franchise, to avoid unwittingly assisting their clients in becoming unintentional franchisors, as well as inadvertently contracting with unintentional franchisors. Business attorneys should be wary of the presence of a franchise whenever an express or implied trademark license presents itself.

Understanding the Differences between Franchises and Other Business Arrangements

Licensing, Distributorships, and Dealerships. One way to avoid being deemed a franchise is to

structure a transaction so it does not meet the definition of a franchise, assuming that the manner in which the business will be operated allows this. For example, pure 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 party licenses another to sell its products or services in exchange for a specified amount of the sales proceeds without any additional involvement of the licensor that could constitute control over the business operations. True licenses grant licensees limited rights that are related to specific products or services without giving the licensor control over the licensee's business operations. However, if the licensor exercises control over a licensee's business operations, like providing additional support, such as training or promotional assistance that constitutes a sufficient amount of control, the licensor may become a franchisor.

In dealership and distributorship arrangements, independent businesses operate under their own trade names and usually buy products or services from another other party, the supplier, at wholesale prices and then resell them to the public. Generally, distributorship arrangements do not constitute franchises because the "fee" element of a franchise is not met. Payments for the purchase of initial and ongoing inventory at bona fide wholesale prices are not "fees." However, there are several qualifications to the bona fide wholesale price exception. For example the bona fide wholesale price exception:

- is applicable only to the purchase of goods which the purchaser is authorized to distribute by a contract with the seller. The exception does not apply to fixtures, equipment or other articles which are to be utilized in the operation of the business, such as displays, sales kits, or advertising.
- is not available if the amount of goods required to be purchased exceeds the quantity which a reasonable businessperson normally would purchase by way of a starting inventory or to maintain an ongoing inventory.
- will not apply if the price of the goods is negotiable. When the sales price is negotiable, the sellers cannot contend that sales are being made at the bona fide wholesale price since sales prices will vary according to the ability of the purchaser to negotiate.

Franchises Require Pre-Sale and Ongoing Legal Compliance

Franchise Registration.

Franchising is a highly regulated industry. Under the CFIL, it is unlawful to offer or sell a "franchise" in California unless the offering has been registered with the DFPI or it is exempt from registration. If a business relationship includes he elements of a franchise under California law, the franchisor must: (i) file a franchise disclosure document with the DFPI 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; (ii) 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 (iii) obtain DFPI approval for any "material modifications" to its registered franchise documents before presenting them to franchisees. These burdens are not imposed in pure licensing, distributorship and dealership relationships.

In order to be registered by the DFPI, the FDD must include disclosures of the following, among others, to the satisfaction of the DFPI examiner: (i) the contracts the prospective franchisee is being asked to sign; (ii) the major points of the franchise relationship; (iii) the background of the franchisor and its personnel; and (iv) some of the costs involved in acquiring and opening the franchised business, including a franchisee's initial investment in purchasing the franchised business and ongoing fees paid to the franchisor.

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.

Wrap-up

The determination 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.