Crossing the Line: Don't Let Business Clients Become Accidental Franchisors

By Barry Kurtz and Bryan H. Clements

TOO OFTEN, EXPANSION-minded business owners choose to offer trademarked products or services through purported licensing agreements or distribution or dealership arrangements only to discover, well into the game, that what they have actually done is sell franchises. Becoming an "accidental franchisor" can spell disaster for the unwitting business owner who has stepped over the line that separates franchising from other commercial arrangements involving trademarked goods or services.

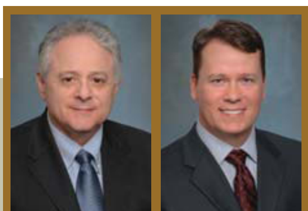
Suppose a business client requests an attorney draft a licensing, dealership or distributorship agreement to allow another business owner to offer his or her business' trademarked products. Without a basic understanding of franchise law, the attorney may miss the warning signs that the proposed business arrangement may create a franchise. Under federal law, as well as in California, it does not matter what the arrangement is called when the agreement is drafted: if the elements of a franchise are present, it is a franchise.

Franchise sellers must comply with extensive pre-sale registration and disclosure requirements or face severe penalties. Attorneys who make such a mistake will have unhappy clients when state regulators come knocking or when a franchisee sues for rescission. To avoid such a problem, every business lawyer should familiarize himself or herself with the following basics of franchise law.

Regulating Franchises in California

Under California law, a business relationship is a franchise if the business will be substantially associated with the franchisor's trademark; if 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 if the franchisee will operate the business under a marketing plan or system prescribed in substantial part by the franchisor.

The Department of Corporations (DOC) regulates franchises in California and interprets the three elements of a franchise broadly. To start with, if a business enterprise uses another company's trademark to identify its business, or in its advertising, there will



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be room to argue that the franchisee's business is substantially associated with the franchisor's trademark. If the other elements are present, making the determination as to whether a franchised business will be substantially associated with the trademark of another business will not be easy, and splitting hairs won't work. This analysis is best left to an experienced franchise attorney.

Just about any payment can be interpreted as satisfying the fee element, regardless of whether the parties call it something else in their agreements. You don't want to find yourself in court or in front of the DOC arguing that a payment is not a fee—it is a losing argument.

The third element, which requires that the franchisee will operate the business under a marketing plan or system prescribed in substantial part by the franchisor, is known as the "control" element. It, too, is broadly interpreted. The following represent a few examples of what may satisfy the control element:

- Providing advice and training regarding the sale of the trademarked products or services
- Exercising significant control over the operation of the franchisee's business
- Granting exclusive rights to sell one's products or services in specific territories
- Requiring franchisees to purchase or sell specific quantities of products or services.

Differences between Franchises and Other Business Arrangements

In the typical franchise arrangement, franchisees sell or distribute their franchisor's trademarked products or services. They usually have exclusive, protected territories, or territories in which the franchisor will not permit other franchisees to operate or to offer the same products or services. Also, it is typical for a franchisor to provide its franchisees with an operations manual containing a tried and true system of operations and to closely monitor the franchisees for compliance to protect the integrity of its systems. In typical franchises, franchisees rely on their franchisors for advice, training, advertising and marketing assistance. Furthermore, franchisors usually mandate the use of specific suppliers, and in some cases, even act as the exclusive supplier of certain products or services sold by their franchisees.

True licensing, distributorship and dealership arrangements are not franchises because they lack at least one of the three elements defined under California law as described above. For example, under a typical licensing arrangement, one company permits another to sell its products or services in exchange for a percentage of the proceeds without any other involvement on the part of the licensor. In dealership and distributorship arrangements, independent businesses operate under their own trade names. The dealers or distributors usually buy products or services from the other party at wholesale prices and then resell them to the public. Neither party is substantially involved in the business affairs of the other.

Why Not Classify Every Arrangement as a Franchise?

In general, a franchise is a contractual arrangement that makes one party or business dependent upon another. Franchise agreements strongly favor franchisors and are typically written by the franchisor's attorneys; franchisees usually have little power to negotiate favorable terms. While franchise agreements are not considered contracts of adhesion, the Federal Trade Commission, as well as many states, have taken the position that these arrangements provide a much greater potential for fraud, which explains why franchises are so

highly regulated, and other business relationships are not.

The prospect of registering a franchise can be quite expensive and time consuming. Expansion-minded entrepreneurs typically prefer to streamline the deal process and will push for the simplest, cheapest option. But keep in mind that any combination of the use of a trademark for a fee and the imposition of the trademark owner's operating methods or systems or other direct involvement in the operator's business will make these relationships a franchise. That is why it is crucial for attorneys involved in setting up any of the above mentioned arrangements to determine whether the practices push the relationship into the realm of franchising and explain to their clients the risks related to a mischaracterization of the relationship.

Under California's Franchise Investment Law (FIL), it is unlawful to offer or sell a franchise in California unless the offering has been registered with the DOC or it is exempt. If an arrangement satisfies the elements of a franchise under California law as listed above, the franchisor must take on burdens not imposed in licensing, distributorship and dealership arrangements.

The franchisor must file a franchise disclosure document with the DOC outlining the franchise opportunity in detail and providing information regarding the franchisor's own background and business experience, among other things, before entering into any discussions with potential franchisees. He or she must also 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. Finally, the franchisor must obtain DOC approval for any material modifications to its registered franchise documents before presenting them to franchisees, including any new or modified provisions regarding royalties, fees, e-commerce, and territorial rights.

Risks of Mischaracterizing of the Relationship

The DOC closely polices franchisor-franchisee arrangements and may assess penalties of $2,500 per violation of the FIL. This apparently modest fine, however, is only part of the story. The DOC also has the authority to require accidental franchisors to provide notice of the violation to all of its franchisees, offer rescission of all contracts related to the franchise, and refund payments made by the rescinding franchisees.

As an example, suppose a company enters into purported licensing agreements with several other companies involving trademarked products or services, unaware that the details of the arrangements have actually established franchisor-franchisee relationships. Further suppose that at some point, one of the licensees who has been losing money discovers the error. If the licensee reports the matter to the DOC, the DOC will likely fine the franchisor and require it to offer all of its inadvertent franchisees the right to rescind their original agreements and get their money back. This applies to each franchisee's original investment, as well as any losses, less profits, they may have incurred.

Needless to say, if the franchisor wishes to continue conducting the same business it will then need to complete the registration process. This can prove painful, even ruinous to the inadvertent franchisor.

For years, business owners have found franchising to be a highly effective expansion strategy. That said, franchising is a highly complex area of the law that lends itself to specialization. Attorneys representing business owners must be able to spot the telltale signs of a franchise to avoid unwittingly assisting their clients in becoming accidental franchisors.