

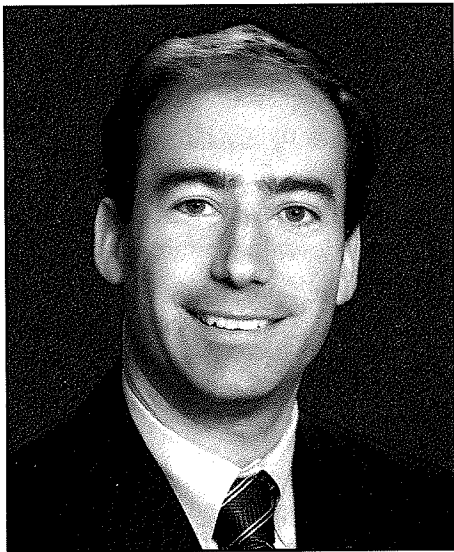
New Matter

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The Unintended Franchise and How to Avoid It



TAL GRINBLAT

Lewitt, Hackman, Shapiro, Marshall & Harlan

INTRODUCTION

IT IS COMMON FOR IP PRACTITIONERS to draft trademark, copyright, patent and other license agreements in their daily practice. If not drafted with care, the agreement may inadvertently include all the elements of a franchise. Franchises are highly regulated in the United States. If a relationship is deemed to be a franchise, the Federal Trade Commission (which regulates all 50 states and U.S. territories) imposes certain pre-sale disclosure requirements before the licensor may enter into an agreement with a licensee.¹ Thirteen states require pre-sale registration before offering or selling franchises to residents or businesses in their states.² Six additional states require notices to be filed with state agencies before sales are made.³ Twenty states regulate the franchise relationship.⁴ Violation of the FTC Franchise Disclosure Rule or the franchise registration or relations acts

of any state may subject the franchisor, its principals, officers and directors to severe penalties, including criminal prosecution. It is therefore important to understand what is a franchise, the elements that comprise a franchise and proactive steps one can take to avoid becoming a franchise.

WHAT IS A FRANCHISE?

When one thinks of a franchise, the types of businesses that come to mind include fast food restaurants like McDonalds® or Burger King®, real estate companies like Century 21® or Coldwell Banker®, or hotel franchises like Marriott® or Hilton®. However, many franchises are not typical. Examples of these include product distributors, car washes, maid service businesses, bakery, sushi departments at supermarkets and others.

What is common to all franchises is that a person/entity sets up someone else's business to provide goods or services to others. In California and other registration states, it makes no difference if the arrangement between the parties is written or oral.⁵ The FTC Rule, however, specifically exempts agreements that are completely oral and where no facet of the relationship is put to writing (such as in purchase orders or invoices).⁶ Furthermore, the name the parties give the agreement does not matter. The agreement may be called a trademark license agreement, know-how license, distributorship agreement, or some other name. As long as the elements discussed below are satisfied, the agreement will be deemed a franchise.

So what is a franchise? Franchises typically have 3 elements: a marketing

plan element (the FTC uses the term "significant control or assistance"), an association with the grantor's trademark and a fee.⁷ This is not the only definition, but it is the most often used definition. Instead of the marketing plan element, some states require the licensor and licensee to have a community of interest (a common financial interest) or for the licensor to provide substantial assistance to the licensee.⁸

The marketing plan element can be satisfied in many different ways, including by providing the licensee a method of doing business, procedures or guidelines to follow (whether through an operating manual or other directives provided to the licensee from time to time), training on how to engage in the business, information on the licensor's methodologies, restrictions on the types of customers and geographies in which the licensee may sell, advertising method protocols, marketing program participation requirements, troubleshooting and other assistance.⁹ Importantly, however, the FTC has opined, that following the requirements will not alone satisfy the marketing plan element. Additionally, the FTC requires the licensor's imposition of trademark controls designed to protect the licensor's rights in and to the licensor's marks, such as inspection rights and restrictions on how to display the marks, imposing health and safety restrictions as required by federal and state laws and assisting distributors obtain financing.¹⁰ As a whole, the key question to look at is the degree of control over the licensee maintained by the licensor and whether participation in the licensor's programs are required or merely optional.¹¹

The trademark association element is typically satisfied through a trademark license whereby the licensee is granted the right in some respect to use the licensor's marks in connection with the licensee's business. The term trademark is defined broadly and includes word marks, slogans, logos, trade names and other advertising and commercial symbols.¹² To avoid satisfying this element, manufacturers, for example, may opt to expressly prohibit the distributor from using the manufacturer's marks. However, if the licensee has the mere option to use the licensor's marks, the trademark element will likely be satisfied.¹³

The third element of a franchise is a fee paid by the licensee to the licensor. This element will be satisfied with virtually any required payment from the licensee to the licensor. Some examples include charging an initial fee for the right to transact business with the licensor, rent, advertising assistance, training, bookkeeping charges, equipment rental fees and continuing royalty charges.¹⁴ In California, the fee must exceed \$500 annually to be deemed a franchise.¹⁵ Other states have similar thresholds.¹⁶ Under the FTC Rule, the fee element will be satisfied if the licensee is required to pay the licensor more than \$500 through first 6 months of operations.¹⁷

But not all charges constitute fees. Certain states and the FTC have exclusions pertaining to the fee element. A fairly common one is if the licensor sells goods to their licensee at a bona fide wholesale price for resale or lease.¹⁸ However, some caution is warranted. The exclusion will not apply to goods that a licensee must use in their own business, such as equipment or business supply purchases.¹⁹ In addition, if a licensor requires a licensee to advertise the licensor's marks, or if a licensee is required to purchase certain promotional materials for use in the licensee's

business, these payments may also be sufficient to satisfy the fee element.²⁰

SO WHAT IF YOU SATISFY THE ELEMENTS OF A FRANCHISE?

Franchises are highly regulated on both the federal and state levels. On the federal level, the FTC Rule on Franchising applies nationwide.²¹ Revamped in 2007, the new Rule requires the Franchisor to provide prospective franchisees pre-sale disclosure on twenty three items. These include disclosure of the identities of the franchisor, its principal officers, directors, parents as well as certain of the franchisor's affiliates' business experience, regulations and laws affecting the franchised business, pending and past litigation history, bankruptcies involving the franchisor and its principals, initial fees and other fees payable to the franchisor over the course of the relationship, estimated initial investment, required franchisee purchases, financing provided by the franchisor or affiliates, initial and on-going support provided by the franchisor, territorial exclusivity and any minimum territory provided by the franchisor, trademarks, patents and copyrights licensed to the franchisee, financial representations regarding potential income the franchisee may earn from the business, personal participation requirements, whether the franchisor uses a public figure to promote the franchise, number of existing outlets in each state, list of franchisees who were terminated, not renewed or ceased doing business, list of franchisees who sold or otherwise transferred their franchise to another, the franchisor's audited financials in the last three fiscal years, and a copy of the franchisor's form agreements that the franchisee may be required to sign.²²

The disclosures are designed to provide the franchisee information on the franchisor and the business, to enable the

franchisee to make an informed decision whether or not to enter into the franchise relationship with the franchisor.

In addition, thirteen states require pre-sale registration before the franchisor offers or sells franchises in that state or to residents of that state. These include California, Hawaii, Illinois, Indiana, Maryland, Minnesota, North Dakota, New York, South Dakota, Virginia, Washington and Wisconsin.²³

Among other reasons cited, these required disclosure and pre-sale registration laws were enacted to protect franchisees from unscrupulous franchisors, to provide a layer of review by state regulators to ensure franchisors planning to sell in these states satisfy certain minimum disclosure requirements, to alert state regulators of the franchises being sold within their borders and to ensure the franchisors have the financial wherewithal to provide the initial services described in the disclosure document, such as initial training and support.²⁴ To enforce these goals, state regulators have the power to deny a registration to franchisors who prepare a grossly deficient disclosure document or who pose a risk to franchisees in their state, to refuse to renew a registration and to require franchisors to escrow initial fees, or to defer charging initial fees until the franchisor's initial obligations to franchisees have been satisfied.²⁵

On top of the franchise registration laws, twenty states regulate the ongoing relationship between franchisees and franchisors.²⁶ These states recognized that regulating the start of the relationship did not sufficiently protect franchisees and that they were still largely at the mercy of franchisors.

The Franchise Relationship Laws, as they are commonly known, generally restrict franchisors from unfairly terminating or refusing to renewing their franchisees during the term of the agreement and at its end.²⁷ The laws

generally prohibit terminating a franchisee unless there is good cause, require the franchisor to provide notice of the alleged breach and an opportunity to cure most breaches, and restrict franchisors from refusing to renewing franchisees at the end of the agreement's term unless certain conditions are satisfied.²⁸

Although outside the scope of this article, there is also a third kind of regulation in this area known as Business Opportunities. Similar to the franchise laws described above, they are regulated by both federal and state laws²⁹ and generally require those who offer business opportunities to comply with certain disclosure requirements, state registration and bond requirements. The definition of a business opportunity is somewhat similar to the definition of a franchise except that the trademark element is generally missing. Common business opportunities are those that grant a purchaser the right to operate a vending machines business, display racks or another type of business whereby the grantor represents that by engaging in the business opportunity, the grantee will likely earn more than the initial investment required to start the business.³⁰

POTENTIAL RISKS OF VIOLATING FEDERAL AND STATE FRANCHISE LAWS

Violating the FTC Franchise Rule and the state franchise registration laws can subject franchisors, their principals and agents to severe penalties.

The FTC has a number of remedies available to deal with persons and entities who violate the Franchise Rule's disclosure requirements. These include injunctions, monetary redress and other remedies. The FTC Act authorizes preliminary and permanent injunctions against Rule violations.³¹ The FTC can freeze the franchisor's assets³² and impose civil penalties of

up to \$10,000 for each violation of the Rule.³³ In addition, the FTC may seek monetary damages on behalf of investors injured economically by a Rule violation.³⁴ The Act also authorizes other remedies as the court finds necessary to redress injury to consumers from a Rule violation, including rescission or reformation of contracts, the return of property and public notice of violation.³⁵

In addition, each of the franchise registration states authorize private and public actions for franchise law violations. In California, the arsenal of remedies available to the government include instituting governmental investigations,³⁶ seeking injunctive relief against the offender, instituting actions for restitution, disgorgement and damages³⁷ and seeking civil³⁸ and criminal penalties.³⁹

Many states also allow for private actions against licensors who violate the state's franchise laws. In California, a licensee has the right to seek damages against the licensor as well as rescission if he can prove a licensor willfully failed to register as a franchise or provide a disclosure document or has made a material omission or failed to state material facts in their disclosure document.⁴⁰ California also provides for personal liability of the franchisor's officers, directors, or employees who aid in the act or transaction constituting the violation.⁴¹ The risks and penalties for violating the franchise laws are therefore real.

CROSSOVER FOR IP LAWYERS

Knowing the definition and what constitutes a franchise is important for intellectual property lawyers. IP lawyers prepare various kinds of agreements including trademark licenses, distribution agreements, patent licenses, know how agreements and others. IP lawyers help clients resolve disputes involving these kinds of relationships

and disputes arising from these types of agreements.

For licensors, there is continuing risk of a license becoming a franchise thereby triggering disclosure and registration requirements. This may occur if the licensor inadvertently includes terms in an agreement that satisfy each of the elements of a franchise. It may also occur over time if, for example, the licensor starts charging new fees (such as fees for brochures or pamphlets) or requires the licensee to attend a training seminar on new products or services. It is not uncommon for an agreement to start out as a mere license and, over time, evolve into a franchise agreement.

For licensees, there are also benefits of knowing what constitutes a franchise for use in litigation, negotiation and dispute resolution. Licensees may use franchise laws to potentially keep an agreement from being terminated, cancelled or not-renewed and to educate the licensor about why the relationship is a franchise and penalties for not complying with the laws. In a lawsuit, licensees may include causes of actions for the licensor's violation of the state's registration and relationship laws. Licensees may also use the franchise laws to potentially demand higher compensation and benefits from their licensor when a violation has occurred.

CONCLUSION

Knowing about state and federal franchise laws is important for intellectual property practitioners. For practitioners representing licensors, knowledge of the definition of a franchise will allow you to develop and draft an agreement that will avoid satisfying the franchise elements. It also provides practitioners the ability to advise clients on how to avoid the definition of a franchise and steps that can be taken to avoid becoming an inadvertent franchise.

For practitioners representing franchisees, knowing what constitutes a franchise is important for strategic reasons. It can help in negotiations, dispute resolutions and litigation with the licensor. ■

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Tal Grinblat is a shareholder of the firm Lewitt, Hackman, Shapiro, Marshall & Harlan in Encino, California. His practice emphasizes franchise and distribution law, trademarks and copyrights. Mr. Grinblat is Chair of the California Bar Association's Franchise Law Committee. He is also a Certified Specialist in Franchise and Distribution law under the State Bar of California's Specialization Program. Mr. Grinblat counsels primarily start-up companies on franchise registration and disclosure matters, terminations, renewals and compliance with federal and state laws.

Endnotes

1. Disclosure Requirements and Prohibitions Concerning Franchising (the "FTC Rule"), 16 CFR § 436.1 *et seq.*
2. These include California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.
3. Notices of franchise sales or an exemption from the state's business opportunity laws must be filed in Florida, Kentucky, Michigan, Nebraska, Texas and Utah prior to selling franchises in those states.
4. Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.
5. See Cal. Corp. Code § 31105(a), Hawaii Rev. Stat. § 482E-2, Ill. Rev. Stat., ch. 121 ½ para. 705/3, Ind. Code. § 23-2-2.5-1, Md. Code Ann. Bus. Reg. § 14-201(e), MI Comp. Laws § 445.1502(3); Minn. Stat. Ann. § 80C.01(4)(a); NY Gen. Bus. § 681(3), N.D. Cent. Code § 51-19-02(5)(a), R.I. Gen. Laws § 19-28.1-3(g)(1), S.D. Codified Laws Ann. § 37-5A-1, Wash. Rev. Code § 19.100.010(4)(a), and Wis. Stat. § 553.03(4)(a).
6. 16 CFR § 436.8(a)(7). See also FTC Franchise Rule Compliance Guide, CCH Bus. Fran. Guide, ¶ 6086, page 9129-200 (May, 2008).
7. California, Illinois, Indiana, Maryland, Michigan, New York, North Dakota, Rhode Island, Virginia, Washington and Wisconsin, define a franchise using the "Marketing Plan or System" element. Cal. Corp. Code § 31105; Ill. Rev. Stat., ch. 121 ½ para. 705/3; Ind. Code. § 23-2-2.5-1; Md. Code Ann. Bus. Reg. § 14-201; Mich. Comp. Laws § 445.1502(3); Minn. Stat. Ann. § 80C.01; N.Y. Gen. Bus. § 681(3), N.D. Cent. Code § 51-19-02(5); VA. Code Ann. § 13.1-559; and Wash. Rev. Code § 19.100.010(4). The FTC uses the "significant control or assistance" standard. See 16 CFR § 436.1(h).
8. Hawaii, Minnesota, and South Dakota define a franchise using the "Community of Interest" element. Community of interest is generally defined as a continuing financial interest between the franchisor and franchisee in operating the franchised business. See Hawaii Rev. Stat. § 482E-2; Minn. Stat. Ann. § 80C.01; and S.D. Codified Laws Ann. § 37-5A-1.
9. The FTC has stated that evidence of the "significant control or assistance" element is present if the franchisor requires the franchisee to obtain site approval, comply with certain site designs or appearance, operate within certain hours; abide by certain accounting practices and personnel policies; participate in promotional campaigns requiring participation or financial contribution, if the franchisor imposes customer and sales area restrictions; promises to assist the franchisee with sales or business training, furnishes an operating manual with detailed information on how to operate the business; provides assistance with accounting, management, marketing or personnel, furnishes a computer network or website for the franchisee's use, and site selection assistance for the franchise. See FTC Franchise Rule Compliance Guide, CCH Bus. Fran. Guide, ¶ 6086, page 9129-197 (May, 2008).
10. FTC Franchise Rule Compliance Guide, CCH Bus. Fran. Guide, ¶ 6086, page 9129-198 (May, 2008).
11. See, e.g., When Does An Agreement Constitute A Franchise, Release 3-F, California Department of Corporations, CCH Bus. Franc. Guide at ¶ 5050.45 (a distribution agreement by which a manufacturer or wholesaler for a fee grants the right to a distributor or retailer to sell a trademarked product purchased from the manufacturer or wholesaler is not a franchise if the distributor or retailer may sell the product according to its own plan without express or implied limitations on the method or mode of sale); *Gentis vs. Safeguards*, 60 Cal. App. 4th 1294 (Cal. App. 1998) (Distributor arrangements held to be franchises, because among other factors, distributors were required to operate pursuant to the manufacturer's guidelines).
12. FTC Franchise Rule Compliance Guide, CCH Bus. Fran. Guide, ¶ 6086, page 9129-197 (May, 2008).
13. See *Lobdell vs. Sugar N' Spice*, 33 Wash. App. 881 at 886 (WA App. 1983), *Kim Vs. Servosnax, Inc.*, 10 Cal. App.4th 1346, 1350 (Cal. App. 1992).
14. FTC Franchise Rule Compliance Guide, CCH Bus. Fran. Guide, ¶ 6086, page 9129-198 (May, 2008).
15. Cal. Admin Code tit. 10 § 310.011 (less than \$500 annually).
16. Ill. Admin Code, Tit. 14 § 200.105 (less than \$500 annually); Md. Regs. 02.02.08.10(c) (less than \$100 annually); Mich. Comp. Laws § 445.1506(6)(c) (less than \$500 annually); Minn. Stat. § 80C.01(4)(c) (less than \$100 annually); Wash. Rev. Code § 19.100.030(4)(b)(iii) (less than \$500); Wis. Admin Code § 32.05(1)(b) (less than \$1,000 annually).
17. 16 CFR § 436.8(a)(1).
18. 16 CFR § 436.1(s), Cal. Corp. Code § 31011; Hawaii Rev. Stat. § 482E-2, Ill. Rev. Stat., ch. 121 ½ para. 705/14, Ind. Code. § 23-2-2.5-1(i)(3), Md. Code Ann. Bus. Reg. § 14-201(f)(3)(i), N.Y. Gen. Bus. § 681(7)(a), N.D. Cent. Code § 51-19-02(6)(a), R.I. Gen. Laws § 19-28.1-3(h)(1), S.D. Codified Laws Ann. § 37-5A-4, VA. Code Ann. § 13.1-559(3), Wash. Rev.

- Code § 19.100.010(12), Wis. Stat. § 553.03(5m).
19. FTC Franchise Rule Compliance Guide, CCH Bus. Fran. Guide, ¶ 6086, page 9129-198 (May, 2008).
 20. See e.g., *To Am Equip. Co., Inc. vs. Mitsubishi Caterpillar Forklift America, Inc.* 152 F. 3d 658 (7th Cir. 1998)(franchise fee was deemed satisfied when Forklift Dealer was required to purchase promotional materials, sales and service publications from the manufacturer). See also, *When Does An Agreement Constitute A Franchise*, Release 3-F, California Department of Corporations, CCH Bus. Franc. Guide at ¶ 5050.45
 21. 16 CFR § 436.1 *et seq.*
 22. 16 CFR § 436.5.
 23. Cal. Corp. Code § 31110, Hawaii Rev. Stat. § 482E-3(c), Ill. Rev. Stat., ch. 121 ½ para. 705/10, Ind. Code. § 23-2-2.5-9, Md. Code Ann. Bus. Reg. § 14-214, Minn. Stat. Ann. § 80C.03, N.Y. Gen. Bus. § 683, N.D. Cent. Code § 51-19-03, R.I. Gen. Laws § 19-28.1-5, S.D. Codified Laws Ann. § 37-5A-6, VA. Code Ann. § 13.1-560, Wash. Rev. Code § 19.100.020, Wis. Stat. § 553.21.
 24. See Cal. Corp Code § 31001, Hawaii Rev. Stat. § 482E-1; Ill. Rev. Stat., ch. 121 ½ para. 705/2; Md. Code Ann. Bus. Reg. § 14-202; N.Y. Gen. Bus. § 680; R.I. Gen. Laws § 19-28.1-2; VA. Code Ann. § 13.1-558.
 25. Cal. Corp. Code ¶ 31113, 31115, 31117; Hawaii Rev. Stat. § 482E-8; Ill. Rev. Stat., ch. 121 ½ para. 705/15; Ind. Code. § 23-2-2.5-9, § 23-2-2.5-12, § 23-2-2.5-14; Md. Code Ann. Bus. Reg. § 14-217, 14-218, 14-221; N.Y. Gen. Bus. § 683(13), 685; N.D. Cent. Code § 51-19-09; R.I. Gen. Laws § 19-28.1-9, 19-28.1-18; VA. Code Ann. § 13.1-561, 13.1-562; Wash. Rev. Code § 19.100.020, 19.100.050; Wis. Stat. § 553.28.
 26. Ark. Code. Ann. §§ 4-72-202, 204 and 209; Cal. Bus. & Prof. Code § 20020, 20021 and 20030; Conn. Gen. Stat. § 42-133(f); Del. Code Ann. Tit. 6 §§ 2552 and 2554; Haw. Rev. Stat. § 482E-6; Ill. Rev. Stat., ch. 121 ½ para. 705/19; Ind. Code §§ 23-2-2.7-1 and 23-2-2.7-3; Iowa Code § 523H.1 to 523H.17 and 537A.10; MD Code Ann. §§ 11-1302.1, 1303, 1304 and 1305; Mich. Comp. Laws § 445.1527; Minn. Stat. 80C.14; Miss. Code Ann. § 75-24-53; Mo Rev. Stat. § 407.405.1; Neb. Rev. Stat. §§ 87-402, 404, 405 and 408; N.J. Stat. Ann. §§ 56:10-5 through 10-7.4; RI Gen Bus. Laws § 6-50-1 *et. seq.*; S.D. Codified Laws § 37-5A-51; Va. Code Ann. § 13.1-564; Wash. Rev. Code § 19.100.180; Wis. Stat. § 135.01-135.07.
 27. *Id.*
 28. *Id.*
 29. 16 C.F.R. § 437.1; AK Statutes § 45.66.010 *et seq.*; Cal. Civ. Code § 1812.200 *et seq.*; Conn. Gen Stats. § 36b-60 *et seq.*; Fla. Stats. § 559.801 *et. seq.*; GA Code § 10-1-410 *et. seq.*; Ill. Rev. Stat., ch. 815 para. 602/5-1 *et seq.*; Ind. Code § 24-5-8-1 *et. seq.*; Iowa Code § 551A.1 *et seq.*; Ky. Rev. Stats. § 367.801; Louis. Rev. Stats. 51-21-1821 *et seq.*; Maine Rev. Stats. § 32-69-B-4691 *et seq.*; Md. Code Ann. Bus. Reg. § 14-101 *et seq.*; Mich. Comp. Laws § 445.902 *et seq.*; Neb. Rev. Stats. § 59-1701 *et seq.*; N.Hamp. Rev. Stats. Ann. Title XXXI, § 358E:1 *et. seq.*; N. Carolina Gen. Stats., § 66-94 *et seq.*; Ohio Rev. Code § 1334.01 *et seq.*; Okla. Stats. title 71, ch. 4 § 801 *et seq.*; S. Carolina Code § 39-57-20 *et seq.*; S.D. Codified Laws Ann. § 37-25A-1 *et seq.*; Texas Bus. & Comm. Code § 41.001 *et seq.*; Utah Code Ann. § 13-15-1 *et. seq.*; VA. Code Ann. § 59.1-262 *et seq.*; Wash. Rev. Code § 19.110.010 *et seq.*
 30. *Id.*
 31. 15 U.S.C. § 53(b).
 32. 15 U.S.C. § 57b(b).
 33. 15 U.S.C. § 45(m)(1)(A)).
 34. 15 U.S.C. § 57b.
 35. 15 U.S.C. § 57b.
 36. Corp. Code § 31401.
 37. Corp. Code § 31400.
 38. Corp. Code § 31406.
 39. Corp. Code § 31410.
 40. Corp. Code § 31300.
 41. Corp. Code § 31302.