The Accidental Franchisor:

What Every Business Lawyer Should Know About Franchise Law

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The Importance of Knowing the Basics

Expansion-minded business owners often offer trademarked products or services through licensing agreements or distribution or dealership arrangements only to discover later 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. When considering franchising, it is important to know the basics. That said, establishing the legal framework for a properly formed franchise relationship is a complex undertaking. To get it right, business owners and their counsel should speak with an experienced franchise attorney before getting started.

Without a basic understanding of franchise law, you may miss the warning signs that a proposed business arrangement may create a franchise. For example, if a business client asks you to draft a licensing, dealership, or distributorship agreement to allow another business owner to sell the client's trademarked products, you will need to ask additional questions. Or, if a client comes to you to discuss contracting to sell another owner's trademarked products, you will need to recognize that this, too, may be a franchise. Unfortunately, under federal law, as well as in California, it does not matter what you call a business arrangement when you draft the agreement; 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 potentially severe penalties. Attorneys who draft agreements that mistakenly create franchises will have unhappy clients when state regulators come knocking or when a franchisee sues for rescission. Knowing the following basics can help you identify franchise arrangements and prevent your ambitious business clients from becoming accidental franchisors or from inadvertently contracting with an accidental franchisor.

Business Relationships Considered Franchises 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.

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

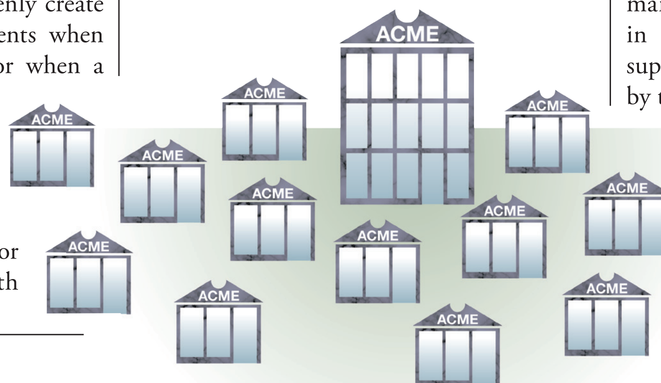
The third element, which requires that the franchisee will operate the business under a marketing plan or system prescribed in substantial part by the franchisor, is known as the "control" element. It, too, is broadly interpreted. The following represent a few examples of what may satisfy the "control" 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; or,
- Requiring franchisees to purchase or sell specific quantities of products or services.

What Differentiates a Franchise From Other Business Arrangements Involving Trademarked Goods or Services?

Characteristics of a Franchise. In short, a franchise is a business relationship between the owner of a trademark and the operator of a business venture utilizing the franchisor's trademark. In the typical franchise arrangement, franchisees offer, sell, or distribute the franchisor's trademarked products or services under a marketing plan or system controlled in substantial part by the franchisor. Franchisees usually want exclusive, protected territories—that is, territories in which the franchisor will not permit other franchisees to operate or to offer the same products or services. Also, a franchisor will typically provide its franchisees with an operations manual containing a tried and true system of operations and closely monitor its franchisees for compliance to protect the integrity of its system. 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.

Licensing, Distributorships, and Dealerships. 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?

Why Franchises Are So Highly Regulated. 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 of the 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.

Franchising May Not Be the Right Fit. For a business owner looking to expand, the prospect of registering a franchise can be quite expensive and time-consuming. Expansion-minded entrepreneurs or businesspersons 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 the relationship a franchise. So, it is crucial for attorneys involved in setting up these 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. On the flip side, buying into a franchise is often more costly than launching an independent business, and franchise business arrangements limit the latitude franchisees have in operating their businesses. Attorneys counseling franchise investors should help their clients consider whether the arrangement is a good fit.

Additional Requirements. Under California's Franchise Investment Law (CFIL), 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: (1) 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; (2) disclose potential franchisees with its registered disclosure document and wait at least fourteen full days before having the franchisee execute any franchise documents or accepting any payments; and (3) 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.

IN BRIEF

A FRANCHISE is a business relationship between the owner of a trademark and the operator of a business venture utilizing the franchisor's trademark.

Risks of Mischaracterizing the Relationship

The DOC closely polices franchisor-franchisee arrangements and may assess penalties of $2,500 per violation of the CFIL. 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.

Wrap-up

For years, business owners have found franchising to be a highly effective expansion strategy, and ambitious entrepreneurs have achieved success by joining proven, well-managed franchise systems in lieu of taking on the risk of creating their own independent businesses. Franchises have many advantages for both franchisors and franchisees. 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, too. Some include: 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.

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, as well as inadvertently contracting with accidental franchisors.

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