The Accidental Franchisor

By Barry Kurtz

When you are representing the expansion-minded client, you have three jobs: spare no effort to keep the client away from the intricacies of franchise law; consult a franchise lawyer when in doubt; and hope that no dispute arises that will turn the client into an accidental, unwilling franchisor anyway.

ENTREPRENEURS, like children on the sidewalk outside an ice cream shop on a summer's day, are hopeful folk. They see any solid uptick in the economy as cause to start thinking expansion — which can bring big-time trouble if expanding includes licensing, dealership, or distribution deals.

Why? Because those who step over a fine line separating many ordinary business arrangements from franchising operations may find themselves unhappily enmeshed in an intricate regulatory apparatus whose dictates govern virtually every aspect of the entrepreneur's business operations. In a worst-case scenario, a misstep can drag the entrepreneur into court to fight state or federal regulators hoping to make the entrepreneur do some jail time, not to mention angry business associates seeking to rescind their deals and maybe collect damages.

To be sure, life rarely gets that hard for the accidental franchisor; as a rule, to do jail time, you have to commit big-time franchise fraud. But franchising is a growth industry, and many expansion-minded entrepreneurs have gone down the franchising road to success. Many others, however, cobble together what they believe to be licensing arrangements or distribution or dealership systems involving trademarked goods or services only to find that, in the eyes of the law, the arrangements look and smell like franchise arrangements.

That can spell trouble, because franchising is not for the faint-hearted. Government doesn't much care what companies do in forming ordinary business relationships. It cares a great deal, on the other hand, about the business dealings of franchisors, whom it generally considers bad guys on the prowl for good guys, otherwise known as franchisees. To keep them at bay, the government requires franchisors to prepare and register complex and costly franchise disclosure documents before they can begin to sell franchises, and it strictly regulates much of their business activities thereafter.

It is the business lawyer's job to draft licensing, distribution, or dealership agreements for expansion-minded clients that remain exactly that — arrangements that do not establish the franchisor-franchisee relationship under either state or federal law, if that is possible. If the franchisor-franchisee relationship is unavoidable, the business lawyer must explain that to clients.

KNOW IT WHEN YOU SEE IT

The first step in getting the job done is to understand what constitutes a franchising arrangement, and what distinguishes a franchising arrangement from other ordinary business relationships. Start with the Federal Trade Commission's definition of a franchising arrangement, which, boiled down, seems simple enough. A franchising arrangement, the FTC says:

- Grants permission to use a trademarked good or service in the conduct of a business enterprise;
- Requires the payment of royalties to the trademark owner;
- Gives the trademark owner significant control over the operations of the business making use of the trademark;and
- May obligate the trademark owner to provide significant assistance — for example, training — to the business making use of the trademark.

State laws take a more specific tack, generally defining a franchisor-franchisee relationship as one in which:

- The franchisee pays a franchise fee to the franchisor plus royalties and possibly payments for inventory, supplies, training, and assistance in order to gain the right to sell or distribute trademarked goods or services under a marketing plan "prescribed in substantial part" by the franchisor;
- The franchisor exercises significant control over the franchisee's business, grants the franchisee exclusive rights to operate in a given territory, and may require the franchisee to purchase or sell a specified quantity of the franchisor's goods or services; and
- The franchisee's business is "substantially associated" with the franchisor such that, for example, the franchisee uses the franchisor's trademark and advertising slogans to identify its business.

These points make clear why many expansion-minded entrepreneurs get into trouble when negotiating licensing, distribution, or dealership agreements. After all, if you don't have the resources to expand by buying up other

companies outright, you need to get their owners to buy into your plans, and that can mean allowing them to use your trademark, granting them territorial rights, helping them with training and perhaps technical assistance, and keeping tabs on them to ensure that all of your work turns into dollars on your bottom line. If you go too far down this road, you turn into a franchisor.

The key to the franchisor-franchisee relationship is that it makes one party, the franchisee, dependent on the other, the franchisor, for many of the elements of a successful business enterprise, including: a valuable and widely known trademarked product or service, an efficient and proven business system, expert advertising, and marketplace dominance. These elements create value, and franchisees pay good money to make use of them in the form of franchise fees and royalties.

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By way of contrast, ordinary licensing, distributorship or dealership arrangements do not make one party dependent on the other. To be sure, money will also change hands, but it will not take the form of royalties — that is, the regular payment by one party to the other of sums reflecting a specific percentage of gross sales. Instead, when money changes hands among parties to licensing, distributorship or dealership agreements, it is usually payment at wholesale prices for goods or services for resale. The parties to such arrangements, in short, do business together, but they do business on their own, too, and remain separate and independent enterprises.

KEEPING ENTERPRISES SEPARATE

The lawyer who helps a client come to any such arrangement must make sure that the contracts documenting the deal do not inadvertently take the client into the world of franchising.

How? Words are important — though not always dispositive when it comes to the vagaries of franchise law — so let's start with the language in contracts covering, say, a licensing arrangement of a trademarked good or service. The language in such contracts must assert that the arrangement is a licensing agreement only, and that the parties do not intend to create a franchisor-franchisee relationship.

Getting the right language into the contracts, however, is not enough. Indeed, it may not matter at all what the contracts say about trademarked goods or services, or about licenses and fees, if the actual business practices of the parties mimic those of franchisors and franchisees. As this makes clear, the control issue is particularly important. If a licensing agreement, for example, imposes only specific limitations on the way the licensee may advertise a trademarked good or service, then the licensor must refrain from trying to impose others — or else re-negotiate the contract.

Clearly, the object of the game for the business lawyer who writes any such agreement is not just to specify that the parties to the agreement do not contemplate creating a franchisor-franchisee relationship even though one may offer training services or they may, in one way or another, do business in training services or become the sole supplier of trademarked goods. The parties must avoid creating a de facto franchisor-franchisee relationship in practice, and it is the job of the lawyers involved to help them understand what is possible and what is not. The contracts the lawyers write may specify that the parties intend to remain independent, but they must remain so in practice, too.

The lawyer who crosses t's and dots i's in any such arrangement keeps trouble away in more ways than one. There is, of course, the state regulatory apparatus, along with its worries about bad-guy franchisors. There is also the erstwhile business associate who, unhappy with the results of a licensing, dealership, or distribution deal, seeks redress in court on grounds that the contracts documenting the arrangement really established a franchisor-franchisee relationship and that, as an injured franchisee, he or she has dibs on a certain pile of treasure.

CONCLUSION

Franchise case law abounds with cases seeking to blur the distinctions between ordinary business arrangements and franchising agreements, and as time goes on, the line separating the two, already fine, will likely become even finer. The business lawyer's first job in preparing any such agreement is to spare no effort to keep the expansion-minded client safely away from the intricacies of franchise law, if it is possible to do so. Then, the business lawyer must consult a franchise lawyer when in doubt. Finally, the lawyer hopes that no dispute arises in the ordinary course of business that will turn the client into an accidental, unwilling franchisor anyway. ■

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