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Franchise Relationships and Licensing Agreements

BY BARRY KURTZ

What's the difference between a franchise relationship and a licensing agreement? Both can spur growth, but there is a fine line between them. The unwary entrepreneur launching an expansion campaign can end up in a world of trouble if he or she doesn't understand the difference.

Indeed, some licensing agreements may, in fact, be franchise arrangements—even if the parties intended to establish some other kind of relationship. It's important to step carefully to avoid becoming an unwitting franchisor, facing serious and potentially painful consequences because complex areas of both federal and state franchise law were not followed.

Under California law, a franchise exists between the owner of an identifying trademark and the operator of a business using the trademark when:

◆ The franchisee engages in offering, selling or distributing goods or services under a marketing plan or system "prescribed in substantial part" by the franchisor;

◆ The franchisee's business is "substantially associated" with the franchisor; and

◆ The franchisee pays a fee to the franchisor or to an affiliated party, directly or indirectly, in order to engage in business.

◆ The first of these conditions exists when the franchisor:

◆ Provides the franchisee with advice and training;

◆ Retains significant control over the conduct of the franchisee's business;

◆ Grants the franchisee exclusive territory; or

◆ Requires the franchisee to purchase or sell a specific quantity of the franchisor's goods or services.

A simple test determines whether the franchisee's business is substantially associated with the franchisor: If the former uses the latter's trademark to identify its business, it is substantially associated with it.

As for fees, they include payments made by a franchisee to a franchisor when signing a franchise agreement and payments made for training and assistance, royalties, or inventory.

Business relationships that do not satisfy these conditions may be licensing arrangements, distributorships, dealerships, or any one of a variety of other business arrangements. However, the distinctions between these arrangements and franchise operations are also subtle and sometimes treacherous.

For instance, a licensing arrangement exists when an independent business operating under its own trade name undertakes to sell products manufactured by a trademark owner and pay the manufacturer a percentage of the sale proceeds. Dealerships and distributorships exist when an independent business operating under its own trade name purchases—typically at wholesale prices—and resells the products of a manufacturer or supplier, with minimal interference by the latter.

In such cases, the key is not whether the business entities entering into the arrangement intend to establish a specific relationship—for example, a distributorship rather than a franchise. The key is whether they operate independently; even though one buys and sells goods produced by the other under a trademark.

The relationship between franchisor and franchisee, by way of contrast, is a dependent one; as evidenced by the arrangements regarding marketing, training, and the like.

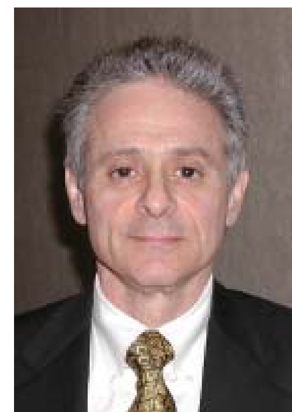
In the real world of business, however, such distinctions are not always apparent. Any business entity that grants another the use of a trademark may unwittingly stray over the line and establish a franchisor-franchisee relationship in the eyes of the law.

When this happens, the franchisor becomes subject to many details of state law that do not apply to companies establishing licensing or other business arrangements—and may face substantial civil, administrative, and even criminal penalties.

For example, franchisors must prepare uniform franchise offering circulars and get them approved by the State Department of Corporations before launching operations. They also must give prospective franchisees at least ten business days to study their offering circulars and any related contracts before signature.

They must also get the Department's approval for any "material modifications" they propose to make to existing agreements before presenting them to franchisees. Material modifications may include new provisions reducing or expanding the rights or obligations of either franchisor or franchisee, including new or increased royalties or fees, or rights to engage in Internet commerce.

California state law presumes that in the relationship between franchisor and franchisee, the former has the advantage; and so goes to great lengths to protect franchisees. Companies establishing franchise operations must step carefully—a good thing for entrepreneurs to know when weighing available options for growing their companies.



Barry Kurtz specializes in franchise law and is Of Counsel to the law firm Greenburg & Bass LLP, Encino. He may be reached at bkurtz@greenbass.com.

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