

legal issues



By Barry Kurtz

THE UNWITTING FRANCHISER

Thinking of expanding your business via some sort of licensing arrangement, or perhaps by finding distributors or dealers for your trademarked product or service? Stop yourself before you go too far, because the last thing you want to do is become an unwitting franchiser – and it's probably more easily done than you think.

In fact, there is a fine line between a franchising operation and such other commercial arrangements as licensing agreements, distributorships, and dealerships involving trademarked goods or services, and if you step over that line, you court a world of trouble.

By definition, under California law, you are a franchiser if you offer, sell, or distribute goods or services through one or more “substantially associated” business enterprises following a marketing plan “prescribed in substantial part” by you in exchange for a fee, whether collected directly or indirectly, from those enterprises.

As to what makes one business substantially associated with another, the test is simple: If one uses the other's trademark to identify its business, it is substantially associated with it.

You may also be a franchiser if you allow the associated enterprise to use your trademark and you:

- Provide the associated enterprise with advice and training with respect to your product or service, or
- Retain significant control over the conduct of the associated enterprise, or
- Grant it exclusive territory rights, or
- Require it to purchase or sell a specified quantity of your goods or services.

Clearly, whenever any business enters into an agreement with another for the sale or distribution of trademarked goods or services, the first item on the agenda is to determine whether the agreement is a franchise arrangement.

The key is often the independence of the businesses entering into the arrangement – or the lack thereof. The relationship between a franchiser and franchisee is dependent – the franchisee not only sells or distributes the franchiser's goods or services but also depends on the franchiser for advice and training, advertising and marketing assistance, and exclusive-territory rights. Last but not least, in some cases the franchisee depends on the

franchiser to supply the goods or services it sells.

By way of contrast, licensing, dealership, or distributorship arrangements involve independent business enterprises, however difficult it may be to make the distinction. Thus, if you want to license your goods or services, make your deal with a business operating under its own trade name that will sell them in exchange for a percentage of the proceeds, with minimal involvement by you. If you want a dealership or distributorship arrangement, make a low-maintenance deal with a business (again, one that operates under its own name) that will purchase your goods or services at wholesale prices for resale. While you may not be a franchiser under these arrangements, you lose the opportunity to expand your brand by having multiple units operating under your trademark.

What dangers await the unwitting franchiser? In California, police power over franchise operations rests with the state Department of Corporations, which focuses its efforts primarily on fraud artists who try to sell bogus franchises to an unsuspecting public and keeps no data on its enforcement efforts regarding businesses that step over the line in all innocence.

Even so, state law permits the department to assess penalties at \$2,500 per violation of franchise law, which might prove painful enough if the danger ended there – which it doesn't.

Suppose you enter into five agreements with other businesses involving your trademarked goods or services, not knowing them to be franchise arrangements. You discover your error later on and at some point decide that you really do want to franchise your business. Before the Department of Corporations will let you do so, it will require that you atone for the wrongs you've done by offering the original five franchises the right to rescind the arrangement and get all their money back. Because this can mean returning not only their original investment but also any losses they may have suffered in the meantime, less any profits, it can prove quite painful. In fact, it can wreck your plans altogether.

Franchising, in short, is a complicated business. But if you go about it the right way, it can prove highly profitable.

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Be careful
if your company
sets out to sell
or distribute
goods or services
through licensing
agreements.