Structuring Licenses to Avoid the Inadvertent Franchise
By Rochelle Spandorf

Trademark licensors beware. Is your license or distribution agreement really a franchise? In *Gentis v. Safeguard Business Systems,* a business forms supplier retained commissioned sales agents to solicit orders, follow leads, and provide customer service. While the agents did more than just take orders, they lacked authority to enter into binding sales contracts with customers, bought no inventory, seldom made deliveries, and did not handle customer billing or collection. When the parties’ relationship soured, the agents sued the supplier for violating California’s Franchise Investment Act, the first franchise sales law in the country and the model for the federal and state franchise sales laws that followed. To the supplier’s surprise, the California appellate court found the relationship to be a franchise.

In *Charts v. Nationwide Insurance Co.*, a Connecticut federal district court found an insurance agency to be a franchise and concluded that Nationwide had wrongfully terminated the agency without good cause in violation of Connecticut’s Franchise Act, justifying a $2.3 million judgment award. While the judgment was eventually reversed three years later on different grounds, it temporarily rocked an industry that never seriously considered that insurance agents might be franchisees.

In *Gabana Gulf Distribution Ltd. v. Gap International Sales, Inc.*, a U.K. company appointed as Gap International’s exclusive distributor in the Middle East sued the apparel giant for wrongful termination under California’s Franchise Relations Act after Gap changed its international distribution strategy and terminated the parties’ distribution agreement without cause as expressly permitted by the contract. Claiming its relationship with Gap was a franchise, the distributor sought protection under California’s statute that requires good cause to end a franchise relationship. Three years after Gap lost its motion to dismiss the franchise claim, Gap finally prevailed on summary judgment holding the distribution arrangement was not a franchise, but it spent considerable time and resources to reverse the preliminary ruling.

Even the Girl Scouts have been ensnared by the franchise dragnet! In *Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the United States of America Inc.*, the Seventh Circuit enjoined the national Girl Scouts organization from ending its relationship with a local council after finding the parties’ arrangement fell within Wisconsin’s fair dealership law, which protects dealers and franchisees alike against termination without good cause.

These decisions involve different, but typical, distribution and licensing arrangements for the offer, sale, or delivery of branded goods or services identified by the seller’s trademark. In none of these cases did the parties intend to form a franchise relationship. No investor paid cash to the licensor up front or any type of monthly fee based on gross receipts for the distribution or licensing rights. Certainly no licensor expected to end up defending franchise allegations.

Yet, these situations arise with considerable frequency. Manufacturers, suppliers, and other trademark owners overlook a possible franchise connection when they enter into relationships with independent third parties to sell their branded products or services. Embedded in these distribution arrangements is a de facto trademark license. While not every trademark license creates a franchise, every franchise contains a trademark license.

Given the prevalence of franchising and the interstate, national, and even international scope of so many franchise networks today, attorneys need to know about potentially applicable federal, state, and foreign franchise laws. Franchise sales in the United States are subject to dual regulation at the federal and state level, depending on where the parties reside or do business. The federal franchise sales law, originally adopted in 1978 and overhauled in 2007 regulates franchise sales in all 50 states, including wholly intrastate transactions, per the 2007 version of 16 C.F.R. § 436 (hereinafter “Amended FTC Rule”).

Sorting franchise from nonfranchise licenses can be a highly uncertain process. The quality controls that trademark owners must retain over a licensee’s trademark use closely resemble the marketing controls that are characteristic of a franchise. Yet, from a regulatory viewpoint, nonfranchise and franchise licenses are as different as day and night.

Nonfranchise licenses are unregulated private consensual arrangements. Franchises, by contrast, are highly regulated. Franchise sellers must obey elaborate federal and state presale disclosure and registration laws; nonfranchise licensors do not. Many states restrict the conditions under which a franchise may be terminated or not renewed. Some states dictate substantive terms for the franchise relationship. A franchisee cannot waive the statutory protections of franchise laws even if it wants to. A terminable-at-will contract clause cannot be enforced in a jurisdiction that requires good cause to terminate a franchise agreement—even if the franchisee’s attorney actively negotiated the contract.

Franchise law violations carry significant penalties even if the inadvertent franchisor neither knew about the law nor had any intent to violate it. Not only is it a felony to sell a franchise without complying with a franchise sales law, but federal and state franchise agencies have broad powers to punish franchise law violators and may freeze assets, order restitution, issue cease and desist orders, ban violators from selling franchises, and recover substantial penalties. Franchisees have private remedies for state franchise law violations. Besides compensatory damages and, in some states, attorney’s fees, an injured
A party cannot avoid a franchise relationship simply by

franchisee may (1) rescind a franchise agreement for disclosure and registration violations, including fraud in connection with a franchise sale; (2) obtain an injunction to enjoin a wrongful termination or nonrenewal of a franchise; and/or (3) recover damages or restitution.

Furthermore, state franchise laws impose personal, joint, and several liability on the franchisor’s management and owners even when the franchisor is a legal entity. Finally, lawyers who overlook franchise laws may be guilty of malpractice and potentially liable to victims of their client’s wrongdoing. Because the franchise finding is highly fact-specific, franchise allegations are seldom dismissed early in a case on a motion to dismiss, which significantly adds to the nuisance value of an accidental franchise case, especially when the facts are tenuous to begin with.

What Is a Franchise?

Most people think they know a franchise when they see one. In fact, franchising is a method of distribution, not a particular industry. There is no uniform definition of a franchise. As consumer protection statutes, franchise laws are given a sweeping scope by courts. Consequently, a broad variety of unsuspecting business arrangements may qualify as franchises.

At the most basic level, a franchise is defined by the coexistence of three elements: (1) a grant of rights to use another’s trademark to offer, sell, or distribute goods or services (the “grant” or “trademark” element); (2) significant assistance to, or control over, the grantee’s business, which may take the form of a prescribed marketing plan or what some jurisdictions more broadly describe as a “community of interest” (the “marketing plan variation” element); and (3) payment of a required fee (the “franchise fee” element).

A franchise finding hinges entirely on whether an arrangement fits the applicable statutory definition. If any one statutory element is missing, the relationship is not a franchise. The legal analysis considers the parties’ actual practices, oral as well as written promises, and course-of-dealing evidence. A party cannot avoid a franchise relationship simply by disclaiming its existence. What the parties call themselves is immaterial.

While federal and state jurisdictions that regulate franchises share common definitional approaches, each jurisdiction has its own definitional subtleties and mix of exclusions and exemptions. What qualifies as a franchise under the federal franchise standard, (2) a marketing plan prescribed in substantial part requiring either (1) substantial assistance or control (the federal franchise rule’s business format and product franchise definitions in that most also require the combination of the three basic elements. The trademark and fee elements are fundamentally the same as the Amended FTC Rule. However, state laws differ by requiring either (1) substantial assistance or control (the federal standard), (2) a marketing plan prescribed in substantial part by the franchisor, or (3) a community of interest. A few state laws define a franchise by a two-prong test that omits either the marketing plan or the payment of a required fee.

The Trademark Element

The grant of rights to associate with another’s trademarks in offering, selling, or distributing goods or services is not only a common element of every franchise definition, but also the easiest definitional element to meet. Absent an express prohibition against use of the licensor’s trademark, a right to use the mark will be inferred even if the mark is, in fact, never used. For this reason, every franchise involves an express or implied trademark license of some sort.

Franchise definitions vary from requiring a “license to use” the licensor’s mark to requiring a “substantial association” between the grantee’s business and the licensor’s trademark. Under the “license to use” approach, an express contract authorizing trademark use will support a franchise relationship.

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even if the mark is not part of the licensee’s trade name—for example, Smith’s Appliances, an authorized Brand X Service Center. Permission to display a manufacturer’s logo in dealing with customers satisfies this element. Even without explicit contract authority, longstanding use of a licensor’s trademark in dealing with customers may be enough to establish a trademark license.

Courts have found a requisite de facto trademark license in the following situations.

- A distributor sold uniquely configured branded goods that consumers readily associated with a particular manufacturer in an exclusive territory.21
- A dealer was entitled to identify itself as an authorized dealer of the manufacturer’s products in Yellow Pages advertising.22
- A distribution agreement imposed a duty to use best efforts to promote the sale of branded products.23
- A distributor was required to wear uniforms and add the licensor’s logo or name on delivery vehicles or store windows.24

States following the “substantial association” approach have also found the requisite trademark element satisfied when branded products or services account for a significant percentage of the independent operator’s overall sales.25

Many courts have shown a willingness to stretch the definitional elements to achieve desired results. In one California appellate decision, a substantial association with the licensor’s mark was found even though the licensee was forbidden to use the licensor’s brand name and, in fact, never used it.26 The court was swayed by evidence showing that a building owner had relied on the licensor’s brand name in renting space to the licensee to operate a cafeteria in the building, which was enough to satisfy the substantial association test.27

The Licensor’s Quandary: The fact that an agreement lacks an express trademark license does not prove the trademark element is missing. A de facto license is part of the rights granted to an independent dealer or distributor who is authorized to sell branded products or services accounting for more than an insignificant percentage of the licensee’s overall sales. Since the trademark element’s presence may depend on the extent of actual branded sales, contract drafting may not save a license from being a franchise. A contract that expressly denies a trademark license may leave the licensor, manufacturer, or supplier with the worst of both worlds: an agreement that is subject to various franchise laws but does not contain the protections that a well-drafted trademark license should contain. The Gabana Gulf decision suggests that licensors of branded merchandise may avoid the trademark element by expressly disclaiming any duty to refer customers to the licensee. However, this drafting approach will not work for manufacturers, suppliers, and licensors that view lead generation services or other types of marketing support as vital to their distribution strategy.

The Marketing Plan Variation Element

A handful of states follow the Amended FTC Rule’s approach and require the licensor to furnish significant assistance or impose significant controls over the licensee’s entire method of operation. Significant assistance exists when the licensor provides formal sales, repair, or business training programs; site location assistance; management, marketing, or personnel advice; promotional support requiring the licensee’s participation or financial contribution; or operating advice such as by furnishing a detailed operating manual. Significant controls exist if the licensor approves or restricts the business location or sales territory, specifies design or appearance requirements, prescribes operating hours, establishes production methods or standards, restricts the customers a licensee may serve, mandates personnel policies or practices, or dictates mandatory accounting practices. Under certain circumstances, any one of these factors may be enough to constitute significant control or assistance. Significant promises of assistance, even if unfulfilled, will satisfy this element. However, merely providing point-of-sale advertising and media support may not be enough.28

The franchisee’s reliance on the franchisor’s experience influences whether the licensor’s control or assistance is significant. The franchisee’s general business experience, knowledge of the industry, relative financial risk in light of its total business holdings, and the extent to which the controls or assistance go beyond normal industry practices each bears on the reliance factor.

A number of states define a franchise as a trademark license in conjunction with a marketing plan. The marketing plan element is composed of four distinct components, all of which must coexist: (1) a marketing plan (2) prescribed (3) in substantial part (4) by the licensor. Each component has been separately analyzed by judicial and administrative authority.29

Determining whether a marketing plan exists is inherently subjective and, consequently, difficult to dodge in a written agreement. While judged by the presence of various facts, no interpretative or judicial opinion suggests a minimum number or combination of facts that inherently guarantee a marketing plan’s presence. The parties’ contract, course of dealing, and industry customs are all relevant. The term prescribed has been interpreted to mean something less than mandatory. Consequently, a marketing plan may be prescribed by implication when it is outlined, suggested, recommended, or otherwise originated by the licensor, even when use of the plan is not obligatory.31

Courts differ in the degree of franchisor involvement in a franchisee’s daily business activities that are necessary to support a marketing plan. Some require significant control, such as confining sales to assigned territories, imposing sales quotas, establishing mandatory sales training, or supplying detailed instructions for customer selection and solicitation. Other courts have found a marketing plan based on far less—for example, a promoter’s recommendations, advice, or suggestions even when there is no obligation on the franchisee’s part to observe them, such as suggesting resale prices and discounts, providing demonstration equipment or advertising materials, recommending or screening advertising materials, or providing product catalogs.

What courts identify as a “marketing plan prescribed in substantial part” may actually be basic to most distributorships.32 For example, a marketing plan was found to exist when dealers were required to advertise the manufacturer’s products intensively, conduct a variety of promotions, and
carry the manufacturer’s array of accessory sales devices; thirty-three distributors marketed products pursuant to a comprehensive advertising and promotional program developed by the supplier, who reserved the right to screen and approve all promotional materials used by distributors; thirty-four distributors were required to perform warranty services in accordance with the manufacturer’s warranty policy, send representatives to sales meetings, complete the manufacturer’s factory service training program, maintain minimum inventory levels, hire an extra salesman, and provide periodic sales reports to the manufacturer; thirty-five a promoter promised to provide a marketing plan even though it failed to deliver on its promise. thirty-six Administrative and judicial opinions try to forge a distinction between production-type controls, which do not result in a marketing plan, and marketing controls, which do, but the distinction between the two has never been well articulated. thirty-seven A marketing plan can exist even when the controls or advice do not relate to advertising or marketing matters, such as when a manufacturer provides detailed instructions and advice regarding operating techniques and skill training that make independent businesses appear as if they are centrally managed and follow uniform standards.

Several states follow the community of interest model, rather than the marketing plan or assistance/control approach, but differ in how they define this element. However, all these states agree that a community of interest exists when parties derive fees from a common source—a standard that potentially encompasses every distributorship and license. thirty-eight

The Licensor’s Quandary: Because the trademark element of a franchise is so easily established, trademark licensors may be tempted to avoid a franchise finding by eliminating the second definitional element—some form of assistance to or control over the licensee’s business. This creates a dilemma because the federal Lanham Act imposes an affirmative duty on licensors to control the quality and uniformity of goods and services associated with their federally registered trademarks. Failure to do so may result in abandonment of trademark rights. As a practical matter, it is often impossible to distinguish trademark quality controls from the factors identifying substantial control, a marketing plan, or a community of interest. It may also be inadvisable to try to avoid franchise laws by eliminating or modifying contractual provisions designed to protect product or service quality or set operating standards that identify the licensee with a larger branded network. A licensor that eliminates or reduces quality controls may not only sacrifice important core values vital to the business and brand—it may risk abandoning its trademark rights.

The Required Fee Element

The required fee element captures all sources of revenue paid by a franchisee to a franchisor for the distribution rights or license. The element is deliberately expansive, encompassing lump-sum, installment, fixed, fluctuating, up-front, and periodic payments for goods or services, however denominated, whether direct, indirect, hidden, or refundable. thirty-nine Under federal law, imputation of a franchise relationship can be avoided by deferring required payments over $500 for at least six months after the licensee or distributor begins operations. The federal franchise definition requires the franchisee to make a minimum payment of at least $500 within that time frame. forty A license will not be deemed a franchise under federal law even if the licensee signs a nonnegotiable, secured promissory note (with no acceleration clause) promising to pay the licensor $500 or more after six months. While this exemption offers interesting structuring opportunities for franchises sold in states without franchise laws, it has no counterpart in most states with franchise laws. Deferral of fees, therefore, is not a universal solution for avoiding franchise status.

All jurisdictions exclude payments that do not exceed the bona fide wholesale price of inventory if there is no accompanying obligation to purchase excessive quantities. To qualify, the payment must be entirely for goods for which there is a ready market. forty-one Most product distribution arrangements rely on the bona fide wholesale price exclusion in structuring nonfranchise distributorship or dealership programs.

For the fee element, only required payments count, not optional ones. Nevertheless, calling something optional is not necessarily controlling. Payments, though nominally optional, will be deemed required if they are essential for the successful operation of the business. forty-two Finally, to be classified as a required fee, the payment must be made to the licensor or its affiliate or for their benefit as the quid pro quo for the licensing or distribution rights. For this reason, commissions paid by a licensor to a licensee are not franchise fees because no money flows to the licensor. forty-three If, by arrangement, a licensee is required to discharge the licensor’s debt to a third party, or a third party remits a portion of the licensee’s payments to the licensor, an indirect franchise fee exists.

There remains lingering confusion about whether and when ordinary business expenses paid to third parties to establish or maintain a business qualify as a required fee. All jurisdictions that have considered the issue, except Indiana, have held that franchise fees are confined to payments to the franchisor (or an affiliate, or for the benefit of either) and exclude payments to third parties. forty-four Nevertheless, confusion persists over when required payments to a licensor are merely ordinary business expenses and not for the licensing or distribution rights. For example, advertising fees paid to a licensor are commonly classified as franchise fees. forty-five However, a decision under the Minnesota Franchise Act found advertising fees paid to a supplier to be ordinary business expenses where (1) the fee was not based on the retailer’s gross or net sales, but on the amount of inventory purchased from the supplier; (2) the supplier derived no income or profit from the advertising fee and supposedly took nothing out of the advertising fund to cover its administrative costs; and (3) the supplier kept the fees in a segregated account and did not commingle them with its own operating revenues. forty-six Co-op advertising fees common to beverage and other distribution programs—where the supplier matches the distributor’s contribution and spends the funds entirely to promote the brand—have also been found to be ordinary business expenses when the distributor is free to opt out of participating in the supplier’s marketing programs. forty-seven
At the same time, payments to a licensor for equipment and other items that may be purchased, and are readily available, from other sources should not be classified as franchise fees simply because the licensee chooses to buy the items from the licensor and not shop elsewhere.48

While a franchise fee—direct or indirect—is generally a prerequisite for application of federal and state franchise sales laws, it is not a prerequisite for the application of several relationship laws regulating termination, nonrenewal, and other substantive conditions of the parties’ relationship.49 As noted, a handful of state franchise and dealer relationship laws regulate arrangements defined by a two-prong test that omits the required fee element.

The Licensor’s Quandary: For the trademark licensor trying to avoid a de facto franchise agreement, the fee element is the easiest of the three definitional prongs to avoid. A manufacturer or supplier of branded goods that limits its compensation from a distributorship or dealership to the difference (markup) between its cost of goods and the bona fide wholesale price at which it sells the goods to distributors or dealers can lawfully avoid the franchise laws in all jurisdictions that use a three-prong definition. This is true regardless of how closely the licensor, manufacturer, or supplier controls the distribution process or how much the supplier’s markup is.50

Often a trademark owner is in a position to collect a premium from those who want to affiliate with its brand. A manufacturer or supplier may impose innocuous payments for noninventory materials or support services, like sales manuals, demonstration kits, point-of-sale materials, or bookkeeping services, not suspecting that these payments may be enough to constitute a franchise fee.

Some branded affiliations do not involve the purchase of inventory, like service businesses and technology alliances. In these relationships, the bona fide wholesale price exception is not available, and all payments that flow from the licensee to the licensor are potentially franchise fees.

Frequently, licensors, manufacturers, and suppliers do not awake to the reality of the franchise relationship until years after it is formed when they seek to end the relationship pursuant to an at-will termination provision in their contract. Franchise relationship laws prevent the licensor from ending the relationship unless the licensee is in material breach, the essential basis of good cause. Because franchise laws cannot be waived, once a fee is paid anytime during the parties’ affiliation, a licensor may find itself foreclosed from reverting to nonfranchise status even if the licensor offers to refund the unintended franchise fee.51 The dilemma for the trademark licensor is that, in order to escape franchise regulation, it may be required to leave dollars on the table.

Every U.S. jurisdiction regulating franchises has its own mix of definitional exclusions and exemptions, offering a complicated and often confusing maze of structuring opportunities and limitations for companies considering regional or national expansion. Some exclusions and exemptions are common to most, or all, jurisdictions52 while others are unique to a particular jurisdiction.53

Accordingly, individual statutes must always be checked. For example, the Amended FTC Rule and some, but not all, regulating states exclude or exempt arrangements referred to as fractional franchises in which less than 20 percent of the licensee’s revenue is derived from sales of the licensed brand.

Accidental Franchises

Because branding is increasingly important in consumer purchasing decisions, accidental franchises occur more frequently today than when franchise laws were first enacted in the 1970s. Accidental franchises occur because franchise laws poorly articulate the distinction between nonfranchise and franchise licenses.

Every branded distribution arrangement involves an implied, if not an express, trademark license. Strategic affiliations between brand owners, with each owner giving the other the right to affiliate publicly with the other’s brand, are, at a minimum, de facto licenses. With few exceptions, the brand owner’s equity stake in a joint venture will not save the joint enterprise—a distinct legal entity—from being classified as a franchisee.

Each time a license, distributorship, strategic trademark alliance, or other type of branded joint venture or marketing affiliation is formed, the cornerstone of a franchise potentially is laid. Given the prevalence of technology-related licenses and co-branding programs today, that cornerstone may be laid more often than brand owners realize.

Courts have shown no sympathy for trademark owners that defend franchise claims by pleading ignorance of the law or no intent to create a franchise.54 Modeled after U.S. security laws, franchise statutes impose strict liability, thereby making a defendant’s intent or knowledge of the law irrelevant.55 Franchise laws have their roots in consumer protection legislation, and, as a consequence, are construed liberally.

Given the serious consequences flowing from an accidental franchise, lawyers should suspect a franchise whenever an express or de facto trademark license presents itself. Strategic branding alliances, joint ventures, sales agencies, distribution cooperatives, and technology licenses should all be viewed suspiciously as hidden franchises and closely inspected to see if money is being paid, directly or indirectly, by one party for the right to associate with the other’s trademarks.

Certain aspects of the franchise definition, like the marketing plan, community of interest, and substantial assistance and control elements, are so inherently imprecise that it is difficult to render an opinion to a client that an arrangement does not contain at least some indicia of a franchise. The key is knowing how many factors are enough to tip the scale.

Counsel should never rely on contract terminology or disclaimers, neither of which will defeat deemed franchise status. Yet contract drafters are not without tools. A license or distribution contract deliberately structured to avoid a franchise definitional element or take advantage of a statutory exemption or exclusion should express these facts in the contract. While self-serving and certainly not bulletproof, the plain language will aid, and possibly influence, the fact-finder’s analysis of the franchise claim.

Structural solutions may save some relationships from the reach of franchise laws but often come at the price of sacrificing essential economic objectives or competitive opportunities.
The regulatory burdens of being deemed a franchisor should be kept in perspective. Numerous companies comply with federal and state franchise laws and sustain and grow successful, viable businesses. They compete in the marketplace while complying with presale disclosure and annual registration duties, close franchise sales while honoring rules restricting promises about future earnings, and manage franchise relationships while respecting laws requiring good cause for termination or nonrenewal.

In the long run, the costs associated with franchise avoidance, be they added business risks or extra legal expenses, may be more painful than franchise law compliance. Companies are short-sighted if their overwhelming desire to avoid legal regulation as a franchise drives their business decisions and strategic objectives.  

Endnotes

3. Chartshala v. Nationwide Mut. Ins. Co., 538 F.3d 116 (2d Cir. 2008). The Second Circuit found that the agent abandoned its franchise claim when it deliberately failed to schedule the agency agreement as an asset in filing for Chapter 7 bankruptcy years earlier. This spared the court from addressing the substantive issue of whether an insurance agency is a franchise under Connecticut law.
4. Unlike other industries, insurance groups did not participate in public hearings in the 1970s on the original FTC Franchise Rule. Back then, the insurance industry probably assumed it had no connection to franchising. Since then, at least a dozen reported decisions under different state franchise laws have considered whether an insurance agency is a franchise. While Charts is the only reported decision to rule for the agent, insurance companies continue to face the prospect of franchise claims. See, e.g., Bucciarelli v. Nationwide Mut. Ins. Co., 2009 U.S. Dist. LEXIS 30181 (E.D. Mich. 2009) (franchise claim not dismissed, but court expressed skepticism that the agent could prove it had a franchise fee under Michigan’s franchise law).
5. 2006 U.S. Dist. LEXIS 59799 (N.D. Cal. 2006), summary judgment granted to defendant in 2008 U.S. Dist. LEXIS 1658 (N.D. Cal. Jan. 9, 2008), aff’d, 2009 U.S. App. LEXIS 18996 (9th Cir. 2009) (“Gabana Gulf”). In 2006, the court refused to dismiss the franchise claim; in 2008, the court tossed out the franchise claim on summary judgment; and in 2009, summary judgment was affirmed. The three-year ordeal illustrates the nuisance cost of an accidental franchise claim.
6. 549 F.3d 1079 (7th Cir. 2008).
7. Some franchise statutes specifically limit their application to “continuing commercial arrangements” and do not apply to not-for-profit arrangements. The Wisconsin statute addressed in Girl Scouts of Manitou Council makes no distinction between “for-profit” and “not-for-profit” arrangements. Id. at 1092.
8. The Amended FTC Rule requires presale disclosure, but there is no duty to register with a federal agency. California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin have franchise sales laws coupled with some obligation on franchisors to register the franchise offer with a state agency. The Amended FTC Rule supplements state franchise sales laws but does not preempt them. Roughly half the states also have some type of relationship law protecting franchisees against termination or cancelation of the franchise without good cause.
10. There is no private right of action for violations of the Amended FTC Rule, which only the FTC may enforce. Private parties may have remedies under state unfair trade laws based on Amended FTC Rule violations.
12. See Alexander M. Meiklejohn, UBOCs and Common Law Claims Against Franchise Counsel for Negligence, 25 Franchise L.J. 45 (Fall 2005).
14. The Amended FTC Rule excludes purely oral agreements from its franchise definition, but most state franchise definitions apply to both oral and written contracts.
17. Federal Trade Commission, Compliance Guides, 72 Fed. Reg. 15444 (Mar. 30, 2007). Originally, the FTC Rule applied to a third type of franchise, business opportunity ventures, akin to franchises, but without the trademark element (e.g., vending machine routes and work-at-home programs). The FTC now regulates business opportunities in a separate rule, 16 C.F.R. Part 437.
18. California’s franchise definition, a three-prong definition, expresses the right to offer, sell, or distribute goods or services in the disjunctive, making it broader than some other three-prong definitions. Gentis v. Safeguard Bus. Sys., 60 Cal. App. 4th 1294, 1300 n.1 (1998) (“By using the word ‘or,’ the Legislature intentionally broadened the scope of the statute.”).
19. Arkansas, Connecticut, Delaware, Missouri, Nebraska, New Jersey, Wisconsin, Puerto Rico, and the U.S. Virgin Islands have relationship laws that define the protected relationship without reference to payment of a required fee. Two-prong definitions potentially sweep a far broader range of business arrangements than three-prong statutes.
20. The California Department of Corporations, which enforces California’s Franchise Investment Law, elaborates on California’s franchise definition in Release 3-F, When Does an Agreement Constitute a “Franchise”? (rev. June 22, 1994), available at http://www.corp.ca.gov/commiss/rel3f.htm [hereinafter Release 3-F]. Regarding the trademark grant, it says: “[i]f a franchisee is granted the right to use the franchisor’s symbol, that part of the franchise definition is satisfied even if the franchisee is not obligated to display the symbol.” Release 3-F has been cited favorably by other courts and franchise agencies in interpreting other franchise laws.
25. States do not construe “substantial association” uniformly. There is no universally recognized minimum percentage of branded product sales that qualifies as a “substantial association” with a supplier’s trademark. The Amended FTC Rule and a number of state laws exempt “fractional franchises” from regulation, generally defined as multinline distributorships where sales of any one brand make up less than 20% of the distributor’s total sales. However, “substantial association” has been found based on less than 20% branded sales.
27. Gabana Gulf found the trademark element missing from the Gap-Gabana relationship and distinguished Kim v. Servosnax. According to the court, Gap did nothing to lead Gabana’s customers to Gabana, unlike the building owners who had selected Servosnax to set up a branded cafeteria and install an operator to run it. The distinction seems thin: Gabana had exclusive building owners who had selected Servosnax to set up a branded cafeteria and install an operator to run it. The distinction seems thin: Gabana had exclusive

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Valvoline distributor’s argument that merely selling a branded product creates a substantial association with that trademark.
29. Id. Release 3-F explains the components of the marketing plan element and identifies numerous factors indicating a marketing plan.
30. Id.
31. Id.
34. Meadow Fresh Farms, Inc. v. Sandstrom, 333 N.W.2d 780 (N.D. 1983).
37. Whether know-how controls, common to patent licenses, are enough to affect just an aspect of the licensee’s operations (e.g., production) or is more pervasive.
42. Release 3-F, supra note 20.
43. Thuesen v. U-Haul International, Inc., 2006 Cal. App. LEXIS 1736, at *12 (2006), was the first California court decision to explain what constitutes a franchise fee under California’s franchise law. Unfortunately, the discussion was unnecessary to the court’s holding. Following Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128 (7th Cir. 1990) (Indiana law), Thuesen clarified that a franchise fee requires a “firm-specific investment in the franchisor” in contrast to payments for ordinary business expenses. However, Thuesen shed no light on when a payment to a licensor is, and is not, a firm-specific investment. Moreover, the facts showed the U-Haul dealer made no payments at all to U-Haul. Rather, U-Haul deducted from the dealer’s rental concessions expenses for the dealer’s use of a local telephone line, directory listing, and local computer terminal. The idea that commission deductions are not franchise fees is in line with previous interpretations of California law. See Adees Corp. v. Avis Rent a Car Sys., 157 Fed. App’x 2 (9th Cir. 2005).
44. See, e.g., Wright-Moore Corp., 908 F. 2d 128.
45. Release 3-F, supra note 20.
46. R&A Small Engine, Inc. v. Midwest Stihl, Inc., 2006 U.S. Dist. LEXIS 92208 (D. Minn. 2006). The Minnesota decision seem at odds with precedent in other jurisdictions and offers no bright line for distinguishing when payments to a licensor are ordinary business expenses and not for the right to use the licensor’s marks.
47. *Day Distributing Co. v. Nantucket Allserve, Inc.*, 2008 U.S. Dist. LEXIS 57334 (D. Minn. 2008) (Minnesota law), relied on *Midwest Stihl*. In turn, *JICO, Inc. v. Isuzu Motors America, Inc.*, 2009 U.S. Dist. LEXIS 47128 (D. Haw. 2009) (Hawaii law), relied on *Day Distributing*. JICO ruled that marketing fees that an Isuzu dealer was required to pay to cover its share of Isuzu’s advertising costs were ordinary business expenses and not a franchise fee. JICO failed to note that the marketing program in *Day Distributing* was optional, so the distributor’s marketing fees were optional, not required.
48. See, for example, Reg. 200.105 to the Illinois Franchise Disclosure Act, 815 ILL. COMP. STAT. 705/1-44 (1999), excluding payments for items that the franchisor permits the franchisee to buy from third parties and that are readily available elsewhere. See also Hamade v. Sunoco, Inc., 271 Mich. App. 145, 163–64 (Mich. Ct. App. 2006) (franchise fee requires a transfer of wealth; loan repayment was not a franchise fee absent proof of above-market interest rate).
49. See supra note 19.
51. A franchise fee includes payments for the right to enter a business that are made during the course of the business, not just at inception. In *To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift America, Inc.*, 152 F.3d 658, 659–60 (7th Cir. 1998), the Seventh Circuit found that a tractor dealership, which was not a franchise at the inception of the parties’ relationship, became one when the dealer’s incremental payments for sales manuals over the course of eight years exceeded $500, Illinois’s statutory threshold at the time. The idea that a nonfranchise relationship could turn into a franchise sometime after the parties execute a contract adds uncertainty to the status of licensing and distribution arrangements.
52. For example, transfers by franchisees are not regulated by federal or state franchise sales laws if the buyer assumes the seller’s contracts and the licensor’s involvement is confined to approving the buyer’s qualifications.
53. For example, Minnesota exempts burglar alarm franchises and arrangements between local and national airline carriers.
54. *To-Am*, 152 F.3d at 659–60. The Seventh Circuit admonished inadvertent franchisors everywhere: “Legal terms often have specialized meanings that can surprise even a sophisticated party. The term ‘franchise,’ or its derivative ‘franchisee,’ is one of those words.”
55. *Keating v. Superior Court, 31 Cal. 3d 584, 597 (1982).*
56. This article is based in part on *Franchise Player*, an article written by the author for *Los Angeles Lawyer* in December 2006.