Nation's Restaurant News
WWW.NRN.COM
ELECTRONICALLY REPRINTED FROM NOVEMBER 2013 • A PENTON MEDIA PUBLICATION

OPINION

The hidden pitfalls of joint venture partnerships

BY ROCHELLE SPANDORF

Restaurant joint ventures regularly grab headlines. In May, the San Antonio Express-News announced a deal between Steak 'n Shake and an unnamed professional athlete. A month earlier, Ollie & Jax Pub 'n Pizza was touted in the Orange County Register as putting roots down in the California community in a joint venture between the brand's owners and Main Street Concepts.

These strategic alliances form for many reasons, but all aim to combine complementary strengths. The brand owner seeks investors or experienced operators to replicate the restaurant concept in a new market; investors and operators want to hitch their money or sweat equity to the brand's star.

When joint venture, or JV, parties join together, they create a new legal entity, distinct and separate from the one through which the original restaurant operates.

Commonly, for its share of the JV's equity, the brand owner contributes a trademark and "know-how" license, which is a bundle of intellectual property, or IP, that supplies the JV's restaurant with its brand identity. Through the IP license, the brand owner entrusts the JV to replicate its restaurant concept in every dimension. Even if no written license agreement exists, the license is implied in the JV arrangement. A brand owner should not contribute outright ownership of the IP to the JV because doing so would complicate future expansion.

Consequently, in the JV, the brand owner wears two hats: co-owner and IP licensor.

While not all restaurant JVs are franchises, many are.

A franchise is a special type of licensing arrangement defined and regulated by federal and state laws. There is no universal definition of a franchise, but typically, these arrangements include three elements: a trademark license, a bundle of assistance or controls, and a required fee. In selling or awarding franchise licenses, franchisors owe legal duties under federal and state laws. State laws additionally regulate certain aspects of post-sale conduct, including termination and nonrenewal of the franchise license.

Despite legal compliance duties, franchise licensing is a popular and successful growth vehicle in the U.S., especially for restaurant owners. The food sector represents an estimated one-third of all U.S. franchise establishments and accounts for at least half of all franchise employment, according to the International Franchise Association.

A JV is a more nebulous legal arrangement. JVs comprise any common enterprise between two or more participants to help both accomplish a common goal that neither one could achieve separately. JVs may be a one-shot deal or a long-term commitment. JVs that do not qualify as franchises are not regulated by federal or state laws.

By licensing a brand identity to a JV, a brand owner unknowingly lays the cornerstone of a franchise relationship. It is irrelevant that the brand owner did not intend to create a franchise, knew nothing about franchise laws, or never used the "f" word in conversations with JV participants.

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Brand owners frequently assume that co-ownership shields a JV against franchise status. While the assumption is not always wrong, it is always dangerous.

The brand owner's control over the JV's activities is guaranteed by the separate IP license. Consequently, a restaurant JV is no more or less a franchise when the brand owner is a majority or minority owner.

If the other JV participants are truly passive investors, with no say in day-to-day management and only a limited right to vote on extraordinary events such as selling the restaurant, the law goes both ways on whether the JV is a franchise. But, even if it's not considered a franchise, when JV participants are truly passive, the brand owner may have violated federal and state security laws with equally serious repercussions.

It does not take much to turn a trademark license into a franchise: only operating assistance or controls that go to the core of the licensed business, and required payments to the licensor exceeding $500 per year. The operating assistance or controls may be as innocuous as setting the menu, offering training, identifying POS systems, arranging vendor contracts, providing marketing expertise, designing the restaurant's appearance or promising not to open another branded restaurant too close to the JV's restaurant. Franchise laws are liberally construed and cannot be waived by JV participants, even if the participants wish to waive them.

While it may be possible to lawfully structure a JV to avoid classification as a franchise or qualify for an exemption from franchise regulations, a single solution will not work in all jurisdictions.

Often, the structuring approach with the best potential for avoiding franchise status is eliminating the required fee. But avoiding the fee element is easier said than accomplished. The ele-

ment includes direct and indirect payment for the brand association rights — whether paid upfront or over time as a fixed amount or percentage of sales — or for items such as rent, training or marketing. The brand owner's share of profit distributions may also satisfy the fee element.

Arrangements that shield the brand owner from liability or require operator investors to bear a disproportionate share of losses are telltale franchises. When a brand owner forms multiple JVs with the same restaurant concept, each with different operator investors, franchise risks increase.

Franchise law violations carry significant penalties. Not only is it a felony to violate franchise sales laws, but the government can freeze assets, order restitution, issue cease-and-desist orders and recover substantial penalties. Franchisees have private remedies, including damages, attorney's fees and rescission — a court-ordered unwinding of the JV requiring the brand owner to refund capital contributions and losses. Finally, franchise laws impose personal, joint and several liability on the franchisor's key management and owners, even when the franchisor operates through a business entity.

Franchise laws should be carefully considered when JV plans are first formulated so that solutions can be fully explored and expansion pursued without legal risk. If a JV fails and a participant looks to recover its investment, it will be too late to cure inadvertent franchise status. Proper structuring requires an analysis of the laws in each state where the JV operates. And the fact that "everyone" in the restaurant industry uses JVs will not excuse the restaurateur's noncompliance. ■

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