Expert Q&A on Trademark Licensing and Accidental Franchises

Companies that distribute branded goods or services through independent contractors or license their brands are often surprised to discover that these commercial arrangements are actually franchises subject to extensive regulation. Practical Law asked *Rochelle Spandorf* of *Davis Wright Tremaine LLP* to discuss franchising regulation, the legal consequences for an inadvertent franchisor, and how to structure commercial relationships to avoid "accidental" franchise status.

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What is a franchise?

Most people think they know a franchise when they see one (for example, restaurants with golden arches). In fact, franchising is a method of distribution that is not limited to a particular industry. Each time a trademark license, product distributorship, dealership, strategic brand alliance, or comparable marketing affiliation is formed (whether the subject is fast food restaurants, fitness centers, convenience stores, beverages, clothing, car rentals, automobile dealerships, gas stations, delivery routes, or real estate services) the cornerstone of a franchise potentially is laid.

There is no uniform definition of a franchise. While federal and state franchise laws share common definitional approaches, each jurisdiction has its own subtleties and mix of exclusions and exemptions. What qualifies as a franchise under federal law may not qualify under state laws and vice versa. A franchise in one state may not be a franchise in all states that regulate where that business operates.

At the most basic level, a franchise is defined by the coexistence of three elements:

- **A trademark license.** This element involves a grant of rights to use another's trademark to offer, sell, or distribute goods or services. While not every trademark license creates a franchise, every franchise has some form of trademark license.
- **A marketing system.** Depending on the jurisdiction, this element takes one of three variations, but all focus on the licensor's assistance with, or control over, the licensee's entire method of operation causing the public to regard all

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licensed outlets as a unified marketing concept. In some states, the required assistance or control may take the form of a prescribed marketing plan or what some jurisdictions more broadly describe as a "community of interest."

- **A franchise fee.** This element involves payment of a required fee by the licensee.

Franchise status hinges entirely on whether an arrangement meets the applicable statutory definition. The legal analysis considers:

- The parties' actual practices.
- Oral and written promises.
- Course-of-dealing evidence.

A party cannot avoid a franchise relationship simply by disclaiming its existence. If the statutory definitional elements coexist, the relationship is a franchise even if the parties studiously avoid using the term in referring to their arrangement.

How do accidental franchise claims arise?

Typically, accidental franchise claims arise after a distribution or licensing arrangement falls short of the distributor's or licensee's expectations or the licensor terminates the contract without cause as permitted by the parties' contract. In some cases, accidental franchise claims are brought by unhappy distributors, licensees, or dealers to prevent a licensor or supplier from imposing network-wide changes. Unhappy licensees and a licensor's competitors will often tip off government agencies about franchise law violations they believe have taken place, ultimately leading to public enforcement actions on behalf of injured licensees.

Accidental franchises are also exposed in the due diligence process that accompanies the sale of a company or strategic investment by private equity or venture capital firms. Questions about compliance with franchise laws in forming or ending licensing agreements may torpedo a lucrative deal. Even if the transaction proceeds, investors may insist on lowering the purchase price, staggering payouts, requiring personal guarantees, or other price adjustments. Consequently, accidental franchises are potentially costly mistakes.

What are some examples of business arrangements challenged as franchises?

Remarkably diverse business arrangements have been challenged as franchises, including established organizations and sophisticated companies. For example:

- The Seventh Circuit enjoined the national Girl Scouts organization from ending its relationship with a local Girl Scouts chapter after finding that the parties' arrangement was subject to the Wisconsin Fair Dealership Law, which protects dealers and franchisees alike against termination without good cause (*Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the U.S. Inc.*, 549 F.3d 1079 (7th Cir. 2008)).
- Global fashion brand, Gap, was sued by its exclusive distributor in the Middle East for wrongful termination under the California Franchise Relations Act, which requires good cause to end a franchise relationship, after Gap changed its international distribution strategy and terminated the parties' distribution agreement without cause as expressly permitted by the contract. Three years after losing a motion to dismiss the franchise claim, Gap finally won on summary judgment holding that the distribution arrangement was not a franchise. However, Gap spent considerable time and resources to reverse the preliminary ruling. (*Gabana Gulf Distrib., Ltd. v. Gap Int'l Sales, Inc.*, 2006 WL 2355092 (N.D. Cal. Aug. 14, 2006), summary judgment granted to defendant, 2008 WL 111223 (N.D. Cal. Jan. 9, 2008), aff'd, 343 F. App'x 258 (9th Cir. 2009).)
- Rental companies Avis and U-Haul and car manufacturer Isuzu were each sued under franchise laws by their respective authorized dealers. After years in court, each successfully defeated franchise status claims. (*Thueson v. U-Haul Int'l, Inc.*, 50 Cal. Rptr. 3d 669 (Cal. Ct. App. 2006); *Adees Corp. v. Avis Rent A Car Sys., Inc.*, 157 F. App'x 2 (9th Cir. 2005); *JJCO, Inc. v. Isuzu Motors Am., Inc.*, 2009 WL 1444103 (D. Haw. May 22, 2009).)
- Bakery route drivers have sued their suppliers for violating franchise laws to prevent changes to route assignments (*Atchley v. Pepperidge Farm, Inc.*, 2012 WL 6057130 (E.D. Wash. Dec. 6, 2012); *Petereit v. S.B. Thomas, Inc.*, 63 F.3d 1169 (2d Cir. 1995)).

Taking each definitional element in turn, is an express trademark license required in a franchise relationship?

No. The trademark element in federal and state franchise definitions varies from requiring a "license to use" the licensor's trademark to requiring a "substantial association" between the licensee's business and the licensor's trademark. The license to use a trademark may be express or implied. For example, each of the following fact patterns may satisfy the trademark element:

- A distribution or dealership agreement that authorizes an independent contractor to sell branded products or services. The arrangement is a de facto or implied trademark license if branded sales account for more than an insignificant percentage of the dealer's or distributor's overall sales.
- Marketing that associates a dealer's business with a supplier's brand, even when the trademark 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 or commercial symbol in dealings with customers.
- Longstanding use of a licensor's trademark in dealings with customers, even without explicit contract authority.

How do the factors that identify a franchise relationship differ from standard trademark license quality controls?

The federal Lanham Trademark Act provides that a mark is deemed abandoned when the owner's course of conduct causes the mark to lose its significance as a mark (15 U.S.C. § 1127). To avoid abandonment, a trademark license will commonly specify standards designed to ensure the quality and uniformity of goods and services associated with a licensee's use of the

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licensed brand. A trademark owner's failure to control the quality and uniformity of goods and services associated with a licensee's use of the licensed brand may result in abandonment of its trademark rights (*Barcamerica Int'l USA Trust v. Tyfield Imps., Inc.*, 289 F.3d 589 (9th Cir. 2002)).

As a practical matter, it is often difficult to distinguish trademark quality controls from the tell-tale facts that satisfy the marketing control element, which vary across jurisdictions. Depending on the particular jurisdiction, the marketing system definitional element may take one of three forms, each of which emphasizes different facts:

- Substantial control by, or significant assistance from, the licensor.
- A marketing plan that is prescribed in substantial part by the licensor.
- A community of interest between the licensor and licensee.

All three definitional variations are inherently subjective and, consequently, difficult to dodge in a written agreement. Courts and franchise agencies disagree on which and how many facts must coexist to prove the marketing system definitional element.

What are some examples of substantial control by, or significant assistance from, a licensor?

The federal franchise law and one state franchise sales law (South Dakota) require a licensor to impose substantial control over the licensee's entire method of operation, or furnish the licensee with significant assistance, in order for a license to qualify as a franchise. Substantial control may be found if the licensor:

- Approves or restricts the licensee's business location or sales territory.
- Sets minimum operating hours for the licensee.
- Restricts a licensee's customers.
- Forbids the sale of competitive products.
- Mandates service standards.
- Dictates mandatory accounting practices or reporting requirements.
- Specifies design or appearance requirements.
- Establishes production methods or standards.

Significant assistance may be found when a licensor provides:

- Formal sales, repair, or business training programs.
- Site location assistance.
- Management, marketing, or personnel advice.
- Operating advice, such as by furnishing a detailed operating manual.
- Promotional support requiring the licensee's participation or financial contribution.

Under certain circumstances, any one of these factors may be enough to constitute substantial control or significant assistance. Promises of significant assistance, even if unfulfilled, will satisfy this element.

What type of marketing plan must be in place for a franchise to exist?

A number of states (California, Illinois, Indiana, Iowa, Maryland, Michigan, North Dakota, Oregon, Rhode Island, Virginia, Washington, and Wisconsin) define a franchise as a trademark license in conjunction with a marketing plan that is prescribed in substantial part by the licensor. The requisite marketing plan is not about traditional marketing or advertising support per se. Rather, its concern is with guidance, standards, or requirements that promote uniformity among independently owned establishments licensed to use a common brand. In practice, the marketing plan and significant assistance/substantial control definitional approaches are alike and established by similar facts.

Court rulings differ with respect to the degree of a licensor's involvement in a licensee's daily business activities necessary to find a marketing plan. Depending on the jurisdiction, a marketing plan may be found based on a licensor's:

- Requirements or restrictions that:
  - confine licensee sales to an assigned territory;
  - impose sales quotas;
  - mandate sales or other minimum training; or
  - give detailed instructions for customer selection and solicitation.
- Recommendations, advice, or provision of materials, even when there is no obligation on the licensee's part to observe or use them, such as:
  - suggesting resale prices and discounts;
  - providing demonstration equipment or advertising materials;
  - recommending or screening advertising materials; or
  - providing product catalogs.

How do states define the community of interest element?

Several states (including Hawaii, Minnesota, Mississippi, Nebraska, and New Jersey) follow the community of interest approach, but differ in how they define this element. Nevertheless, all community of interest states recognize that a community of interest exists when both parties derive revenue from the licensee's sale of branded goods and services, a standard that potentially encompasses every trademark license.

For the franchise fee element, what types of payments to a licensor constitute a franchise fee?

The franchise fee element captures all revenue a licensee pays to a licensor for distribution or licensing rights. This 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.

The federal definition of a franchise requires the licensee to pay more than $500 within its first six months of operation.

Under certain state franchise or dealer relationship laws, an arrangement that is not a franchise at inception may become

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one later if a licensee's combined incremental payments to a licensor exceed the statutory fee threshold. The idea that a non-franchise relationship can turn into a franchise over time adds uncertainty to the status of licensing and distribution arrangements.

What factors are relevant to proving that a payment is a franchise fee?

The franchise fee element involves payment of a required fee by the licensee. To be classified as a required fee, the payment must be:

- **Made to the licensor or its affiliate as consideration for the licensing or distribution rights.** For this reason, commissions that a licensor pays to a licensee are not franchise fees because no money flows from the licensee to the licensor.
- **For the benefit of the licensor or its affiliate, if made to a third party.** However, an indirect franchise fee exists if, for example, a:
  - licensee must discharge the licensor's debt to a third party (such as by paying rental fees to an unaffiliated equipment lessor for equipment that the licensor supplies to the licensee); or
  - licensor receives revenue from third parties that deal with the licensee (such as referral fees from recommended suppliers).
- **Essential for the successful operation of the licensed business.** Fees paid for sales training, display equipment, or marketing tools, though nominally optional, are highly suspect under this standard because use of these items is designed to improve a licensee's performance and outcome. When substantially all licensees opt in to a so-called discretionary program and rarely, if ever, opt out, a licensor may face difficulty proving the so-called voluntary payments are truly optional.

All jurisdictions exclude from the scope of a required fee any payments that do not exceed the bona fide wholesale price of inventory if there is no accompanying obligation to purchase excessive quantities. To qualify for this exclusion, the payment must be entirely for goods for which there is a ready market. Most suppliers rely on this exclusion in structuring non-franchise product distributorship or dealership programs. The exclusion requires suppliers to avoid charging fees for other services offered to distributors or dealers, like fees for training, accounting support, sales tools, display equipment, equipment rentals, software licenses, or uniforms.

If franchise status cannot be avoided, what are the key laws that a licensor must comply with?

Broadly speaking, there are two types of franchise laws that apply to all commercial arrangements regardless of industry:

- **Franchise sales laws.** These federal and state laws govern the formation of franchise relationships and impose stringent presale disclosure requirements. State franchise sales laws also impose some type of duty to file or register with a designated state franchise agency.
- **Franchise or dealer relationship laws.** These state laws govern the substantive terms of the parties' relationship and require good cause for termination or non-renewal, and other substantive contract conditions.

At the federal level, franchise sales in all 50 states are regulated by the Federal Trade Commission. Federal law requires a franchisor to deliver a comprehensive disclosure document to a prospective franchisee at least 14 days before the franchisee pays any money or signs any binding agreement for the franchise rights. Federal law prohibits providing prospects with historical or future earnings information about the opportunity unless financial representations comply with disclosure standards. There is no federal registration duty or relationship law.

Currently, over a dozen states have state franchise sales laws that go beyond the federal presale disclosure duty and require franchisors to register with a state franchise agency before offering or selling a franchise either:

- To a state resident.
- For a location or territory in the state.

About 24 states also have franchise or dealer relationship laws that forbid termination without good cause, adequate notice, or more. These laws override conflicting provisions in the parties' agreement. For example, even if the parties' license agreement allows termination without cause on 30 days' notice, a state franchise or dealer relationship law that requires cause, or a longer notice period, or both, controls.

Some states go further and forbid a franchisor from exercising contractually reserved rights to change the distribution model, remove territory, or impose other competitive changes short of termination. Some states nullify contract provisions that prevent a franchisee from selling distribution rights to a qualified buyer. Franchise laws void a franchisee's waiver of statutory protections even when the waiver is given on the advice of legal counsel in exchange for other contract concessions.

On the other hand, if a state law permits termination on grounds not covered in the parties' contract, a franchisor may not use the statute to end a license agreement for reasons contrary to the parties' bargain. Franchise laws protect franchisees. They do not vest franchisors with additional rights not expressed in the parties' contract.

There are numerous state industry-specific laws that are similar to state relationship laws, but only protect the licensees, franchisees, distributors, and dealers who operate in those industries, such as:

- Wine, beer, and alcoholic beverages distributors.
- Automobile dealers.
- Heavy equipment and farm equipment dealers.

What are the dangers of not complying with applicable franchise laws?

Franchise law violations carry significant penalties even when the inadvertent franchisor neither knew about the law nor intended to violate it. Not only is it a felony to sell a franchise without complying with franchise sales law, but federal and state agencies have broad powers to penalize franchise law violators, including by:

- Freezing their assets.
- Ordering restitution to the franchisee.

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- Issuing cease and desist orders.
- Banning them from selling franchises.
- Assessing substantial fines.

Franchisees also have private remedies for state franchise law violations, and some laws permit franchisees to recover compensatory damages, and also treble damages, lost profits, and attorneys' fees.

Additionally, an injured franchisee may:

- Rescind a franchise agreement for disclosure and registration violations.
- Obtain an injunction to stop the wrongful termination or nonrenewal of a franchise.
- Recover damages or restitution.

State franchise laws impose joint and several personal liability on the franchisor's management and owners even when the franchisor is a legal entity.

While the federal franchise law does not provide franchisees with a private right of action, injured franchisees can find remedies under many state unfair trade practices laws by relying on violation of the federal franchise law as the predicate unfair practice.

Additionally, counsel who overlook franchise laws may be guilty of malpractice and potentially liable to victims of their clients' wrongdoing.

Why are accidental franchises so prevalent?

The increasing importance of branding to consumer buying decisions explains why accidental franchises occur more frequently today than when franchise laws were first enacted in the 1970s. Accidental franchises are also the by-product of franchise laws that poorly articulate the distinction between non-franchise and franchise licenses.

Further, because franchise status is highly fact dependent, franchise claims are easy to allege and tend to resist pretrial motions to dismiss. This, combined with the potential joint and several personal liability of a licensor's management and owners, make franchise claims particularly attractive to plaintiffs looking for settlement leverage in disputes with a licensor.

How can a company minimize the risk of creating a franchise relationship when structuring a brand-related commercial arrangement?

Structuring a commercial arrangement so that it lacks one of the definitional elements will prevent a franchise finding regardless of how extensively the other elements are present in the parties' relationship.

One structuring solution is to eliminate the required fee. For example, a licensor may avoid the required fee:

- **In a product distributorship or dealership arrangement when the goal is to move goods downstream to the ultimate consumer.** In this situation, a licensor can avoid franchise regulation by limiting its compensation to the difference between its cost of goods and the bona fide wholesale price at which it sells the branded goods to distributors or dealers (its mark-up). Courts have been reluctant to look behind a manufacturer's or supplier's wholesale price or find a franchise fee hidden in a bloated mark-up. This structuring solution is not available to licensors of services businesses, like fast food restaurants, fitness centers, pet services, or tax preparation businesses.
- **By setting up a commission arrangement or otherwise structuring the money flow to avoid payments from the licensee to the licensor.** Avis, U-Haul, Pepperidge Farm, and others have successfully defeated franchise claims by structuring the money flow to travel from licensor to licensee, or by arranging for network members to buy tools or services essential for operation from unrelated third parties. However, this structuring solution has its disadvantages. For example:
  - while licenses involving services businesses may use this structuring solution, most licensors find a commission arrangement highly impractical; and
  - commission arrangements often create agency relationships, which increase the licensor's liability risks to third parties for the licensee's wrongdoing.

Under federal law, licensors can avoid franchise status by deferring required licensee payments over $500 for at least six months after the licensee or distributor begins operations. However, this exemption has no counterpart in states with their own franchise laws. A short-term deferral of fees, therefore, is not a universal solution for avoiding franchise status.

In many cases, no structuring solution can save a commercial arrangement from franchise regulation. Moreover, roughly ten state franchise and dealer relationship laws define a franchise by a two-prong test that omits either the marketing plan or, more commonly, the payment of a required fee. These state laws regulate ordinary distributorships, dealerships, and licenses, even those that do not qualify as franchises under the federal franchise law because there is no federal preemption of state laws.

Counsel should never rely on contract terminology or disclaimers, neither of which will defeat franchise status. While contract drafters are not without tools, they must know which structuring options are viable and which ones are simply too costly or risky in the long run.

Licensors should keep the burdens of being deemed a franchisor in perspective. Numerous companies comply with federal and state franchise laws and sustain and grow successful, viable businesses. Structural solutions often come at the price of sacrificing essential economic objectives or competitive opportunities.

Because franchise status requires a technical evaluation of a commercial arrangement under potentially multiple laws with subtle distinctions, accidental franchises are a trap for the unwary. Counsel who assume they know a franchise when they see one may be as surprised as their clients to discover the breadth of franchise laws.

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