

Licensing vs. Franchising a Restaurant ... Explained

By Rochelle Spandorf © 2022

Restaurant owners considering expansion: which is the better growth strategy - licensing your brand name or franchising the entire business process?

If given this choice, most every restaurant owner I have met would opt for a simple brand license. Franchising, they know, comes with all sorts of legal complications. Some restaurant owners may feel their brand would be “dumbed down” or genericized if consumers knew the company was franchising.

But is there really a difference between licensing and franchising when it comes to expanding a restaurant through independent business owners? The answer is no. The restaurant owner’s goals for maintaining the integrity of the brand that it entrusts others to use will invariably result in the brand owner imposing operating and marketing controls over the licensee’s operations that are enough to turn most every restaurant licensing arrangement into a franchise. This is true even when the brand owner becomes an investor in a new joint venture entity formed with a third party who will operate the restaurant on a day-to-day basis. Restaurant owners make a costly mistake by ignoring this reality.

Armed with an appreciation of the legal consequences of franchise status, restaurant owners may be able to find exemption-based solutions that allow them to expand their brand free from significant legal regulation. Here are the basics.

WHAT IS A LICENSE?

Generally, licensing is a method of business expansion whereby a trademark owner (the “licensor”) permits another company (the “licensee”) to use its trade name or commercial symbols (collectively, “trademarks”) to sell specific products or services in exchange for payment of a fee.

Numerous examples of licenses exist in the restaurant/food service space. For example, California Pizza Kitchen, Dunkin Donuts and TGI Friday’s, among many other well-known restaurant chains, license signature products to independent food producers for resale into grocery stores. At one point, CPK claimed over a 30% share of the frozen pizza market by first licensing Kraft, and now Nestlé, to produce and sell CPK branded frozen pizzas through grocery stores.

When granting a license to use a name or trademark, the owner must retain quality control over the licensee’s use of its trademarks. Not only are quality controls essential to prevent a licensee from harming the brand’s reputation, but federal law imposes an affirmative duty on licensors to maintain quality controls or else the licensor may lose its trademark rights.

However, to avoid franchising, the controls that a trademark licensor exercises may not be so great that they infiltrate the licensee's entire method of operation. If they cross this invisible line, the licensing arrangement may actually be a franchise. CPK relies on Nestle's know-how and experience with retail distribution to produce consistent quality CPK branded products according to CPK's recipes. Consequently, CPK may have minimum standards for the end product, but it does not dictate specific production or distribution methods to Nestle or intrude into Nestle's methods of operation.

WHAT IS A FRANCHISE?

Franchising is a business expansion model, not a particular industry. Although franchising frequently is associated with the restaurant industry, businesses as diverse as Charles Schwab (securities) and Pet Passages (pet funeral and cremation services) utilize franchising to expand their footprint.

Every franchise includes a trademark license and payment of a fee, but the nature of the quality controls in a franchise license are more extensive than in a non-franchise license. Sorting franchises from non-franchise licenses is a highly uncertain process. The quality controls that trademark owners must retain over a licensee's trademark use closely resemble the operating and marketing controls that are characteristic of a franchise. Furthermore, franchise status is strictly a function of satisfying a legal definition; it has nothing to do with what the parties call their arrangement.

It does not take much to turn a trademark license into a franchise. All that is necessary are (i) a trademark license; (ii) significant operating assistance or controls that go to the heart of the licensed business; and (iii) required payments to the trademark licensor, which can take any number of forms, including distributions by a joint venture in the form of profit participation. Federal law imposes an affirmative duty on trademark licensors to control the quality and uniformity of the goods and services associated with their trademarks and a licensor that fails to do so may risk abandoning its trademark rights. As a practical matter, it is often impossible to distinguish trademark quality controls that licensors must impose to protect their trademark rights from the factors that identify a franchise. As consumer protection statutes, franchise laws are liberally construed. Furthermore, franchise laws cannot be waived by joint venture participants even if the participants are represented by legal counsel.

WHEN IS A RESTAURANT LICENSE REALLY A FRANCHISE?

To illustrate the difficulty of sorting franchises and non-franchise licenses apart in the restaurant context, consider the hypothetical of Lorenzo's Pies. Lorenzo, the owner of a pair of Lorenzo's Pies pizza restaurants, wants to open a third location, but lacks the capital and bandwidth to hire and manage additional employees at another location. Lorenzo has no shortage of followers clamoring for a "piece of the pie" who want to operate a Lorenzo's Pies restaurant of their own. Taking on passive investors would leave Lorenzo managing distant outposts and more employees. Instead, Lorenzo agrees to allow qualified followers to clone his restaurant concept and use the Lorenzo Pies name if they also agree to adorn their own restaurants with the Lorenzo Pies signature red-check trade dress, adhere to Lorenzo's recipes, stick with Lorenzo's menu, buy proprietary pizza dough from Lorenzo's designated supplier, and pay Lorenzo a fee. Lorenzo will teach them how to prepare Lorenzo's pies according to Lorenzo's secret recipes, allow them to buy Lorenzo's proprietary pizza dough, and help them develop a local clientele by sharing marketing strategies and materials. The legal relationship between Lorenzo and the independent licensees is a franchise.

WHY KNOWING THE DIFFERENCE BETWEEN A FRANCHISE AND LICENSE MATTERS

From a regulatory viewpoint, non-franchise and franchise licenses are as different as day and night. Non-franchise 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; non-franchise licensors do not. Many states restrict the conditions under which a franchisor may terminate or not renew a franchise license. Some states dictate substantive terms for the franchise relationship. A franchisee cannot waive the statutory protections of franchise laws even if it wants to on advice of legal counsel. A franchisor may not enforce a terminable-at-will contract clause in a jurisdiction that requires good cause to terminate a franchise agreement—even if the franchisee’s attorney actively negotiated the contract and the franchisee is given the same right to terminate the contract without cause.

Franchise law violations carry significant penalties even if the inadvertent franchisor did not know about the law and lacked 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. An injured 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; (3) recover damages or restitution; and (4) often recover attorneys’ fees. Furthermore, state franchise laws impose personal, joint, and several liability on the franchisor’s management and owners even if the licensor is a business entity.

What would it have taken Lorenzo to avoid franchise status lawfully and award licenses, not franchises, to operate Lorenzo’s Pies restaurants? Lorenzo could have sold its proprietary dough to licensees and forbidden use them from using the Lorenzo’s Pies brand name and left things at that. However, once Lorenzo added trade dress and operating requirements and dictated a uniform menu and recipes to ensure a consistent customer experience across different licensee-owned Lorenzo’s Pies restaurants, Lorenzo crossed the invisible line from licensing into franchising. Lorenzo did so for good reason. Lorenzo insisted on controlling the licensees’ menu in order to prevent licensees from selling Lorenzo’s Pies along with Chinese or Mexican food. Lorenzo insisted that licensees adorn their restaurants with red-checked decorations to strengthen consumer recognition for authentic Lorenzo’s Pie restaurants. Lorenzo wanted licensees to pay their fair share for the marketing activities Lorenzo created to drive traffic to all branded restaurants. Lorenzo offered licensees front and back-of-the-house training, site selection support, pre-negotiated buying options, and social media tools to ensure that licensees understood how to live up to Lorenzo’s quality control standards knowing that this would benefit both licensees and Lorenzo mutually.

The fact is, when restaurateurs look to expand their footprint using other people’s money and labor, there is no salutary way to ensure brand integrity without imposing the more extensive controls and assistance that indicate franchise status. Unless a restaurant grows by taking on investors and managing new locations itself, one may assume that virtually all solutions involving independent business owners operating a cloned restaurant under the concept owner’s trademark are franchises.

The franchise method of doing business dominates every restaurant industry segment, food concept and day part. Franchising is not just a growth vehicle for fast food and fast casual concepts. Just ask the folks at Ruth Chris Steakhouse.

RESTAURANT JOINT VENTURES

Could Lorenzo avoid franchising by setting up a series of partnerships or limited liability companies each with a different third party owner/operator who will handle day-to-day operations of a different Lorenzo's Pie restaurant? The answer is no.

A typical joint venture arrangement looks like this: the joint venture participants form a new legal entity. It makes no difference if they choose to form a corporation, LLC or partnership: what is relevant is that the joint venture entity is separate and apart from the legal entity through which the brand owner, here Lorenzo, owns the Lorenzo's Pie flagship restaurants and intellectual property. Lorenzo retains ownership of the trademarks, brand features, trade dress, recipes, and all other intellectual property and trade secrets that make Lorenzo's Pies special and allows each joint venture to replicate the Lorenzo's Pie restaurant concept and use the Lorenzo Pie's name at another suitable location in a manner that upholds the high operating standards that customers associate with the Lorenzo's Pie brand. Lorenzo would never consider capitalizing a joint venture by assigning ownership of the Lorenzo's Pie intellectual property since the goal is to expand by forming separate joint ventures with different operators. Consequently, in its relationship with venture participants, Lorenzo, as brand owner, wears two hats: as (i) co-owner of a new joint venture, and (ii) intellectual property licensor. Even if the parties do not memorialize the trademark license in writing, the trademark license is implied in the joint venture arrangement.

By virtue of the trademark license, Lorenzo has awarded the joint venture a franchise. It is irrelevant that Lorenzo did not intend to create a franchise, knew nothing about franchise laws, never used the "F" word in conversations, or owns an interest in the joint venture. By forming a relationship that qualifies as a franchise, Lorenzo has violated federal franchise sales laws and, depending on where the venture operates, may have violated state franchise sales laws as well.

Brand owners like Lorenzo are mistaken if they assume that, by investing in the joint venture, the venture cannot be a franchise. Unless the other venture participants are truly passive investors with no say in day-to-day management and only a limited right to vote on extraordinary events like admitting new members, significant financing transactions or the sale of the restaurant, the venture is a franchise regardless of whether the brand owner is a minority or majority joint venture investor. And, if the other venture participants are truly passive, the brand owner may have violated federal and state security laws with equally serious repercussions. Most restaurant owners in Lorenzo's shoes want third party owner/operators to be active in running day-to-day operations; they are not looking for purely passive investors. In sum, Lorenzo's joint venture strategy does not avoid franchising.

EXEMPTION-BASED FRANCHISING

Brands drive consumers' purchasing decisions and popular brands often have a leg up in the highly competitive food service environment. When restaurants grow by relying on other people's money and labor, the trademark license they offer will invariably qualify as a franchise regardless of what they call the arrangement or the disclaimers they put in their contracts.

Every U.S. jurisdiction regulating franchise sales has its own mix of exemptions from laws that require pre-sale disclosure and registration. Some exemptions provide restaurant brands with opportunities to expand without the expense and trouble of keeping a franchise disclosure document up-to-date and other compliance complexities. Some exemptions excuse franchisors that meet both size and net worth requirements from franchise sales

regulations. Others excuse franchisors from regulation if franchisees meet minimum net worth, experience, or investment size requirements. Others exempt arrangements when revenue from a particular licensed brand is less than 20% of the licensee's revenue from all sources.

Using the right roadmap, restaurant brands can often piece together assorted franchise law exemptions in many important markets. In states where an exemption strategy is not available, restaurant owners may need to forego licensing opportunities or open and operate branded restaurants themselves unless they comply with franchise sales laws. Starbucks, for example, has successfully relied on exemption-based franchising to grow in the United States, owning units in those regulating jurisdictions that did not offer Starbucks an exemption from pre-sale disclosure obligations.

SPECIFIC EXEMPTION SOLUTIONS

Arrangements between restaurant brands and grocery stores, hotels, universities, airports, business campuses and similar types of facilities where the restaurant is located on the property of another business that either operates or outsources operation to a third party (e.g., a concessionaire) are examples of exempt fractional franchises. The operator/licensee has experience in restaurant operations, but does not derive more than 20% of its total revenue from any single brand. Ghost and virtual kitchens are expansion models ripe for the fractional franchise exemption where an experienced operator runs multiple licensed brands out of the same kitchen and does not derive more than 20% of its total revenue from any single brand.

The federal franchise law, which regulates franchise sales in all states, offers several other important exemptions. It exempts franchises awarded to "sophisticated investors," i.e., business entity franchisees in business for at least 5 years (any business counts) with a net worth of over \$6.165M. This exemption allows restaurant brands to team up with well-capitalized hands-on investors even those lacking restaurant experience.

Another federal law exemption applies to franchises awarded to franchisees making "large investments," i.e., where at least one of the franchisee's owners (which may be a business entity) commits to invest at least \$1.23M (exclusive of real estate and financing from the brand owner) in one or more branded restaurants within a prescribed period.

If the restaurant owner's roadmap includes one of the 12 or so states that regulate franchise sales, the restaurant owner must find a separate exemption from the state's pre-sale disclosure and registration requirements. However, the state exemption may differ from the federal exemption.

Exemption-based franchising is a potentially dizzying and sometimes frustrating strategy, but it has enabled some restaurant brands to expand free from burdensome pre-sale disclosure requirements. By relying on an exemption strategy, they can test out new restaurant concepts and open in distant markets leaning on the capital and labor of others.

CONCLUSION

Given the significant legal risks attendant to unlawful franchise sales, restaurant owners that want to expand their footprint by using other people's money and labor may want to explore the availability of franchise law exemptions in the markets they peg for expansion.

When important expansion opportunities offer no exemption solution, restaurant owners should keep the regulatory burdens of being a franchisor in perspective. Numerous restaurant brands utilize franchising successfully and comply with federal and state franchise laws without compromising their brand's integrity. In the end, the costs associated with franchise avoidance, be they added business risks or extra-legal expenses, exceed the price of franchise law compliance.



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