Structuring Licenses To Avoid The Inadvertent Franchise

by Rochelle B. Spandorf

Trademark Licensors Beware: Is Your License or Distribution Agreement Really a Franchise?

In *Gentis v. Safeguard Business Systems*,[1] the defendant retained commissioned sales agents to solicit orders, follow leads, and provide customer service. The agents did more than just take orders, but lacked authority to enter into binding sales contracts with customers, never took title any goods, never bought inventory, seldom made deliveries, and did not handle billing or collection. When the relationship between the agents and Safeguard soured, the agents sued Safeguard for violating California's Franchise Investment Act, the first franchise sales law in the country and the model for both the federal and state franchise sales laws that followed.[2] In one of the few California appellate court decisions interpreting the statute, to Safeguard's surprise, the court found that the relationship between the sales agents and Safeguard to be a franchise.

In *Charts v. Nationwide Insurance Co*.,[3] a Connecticut federal district court found an insurance agency to be a franchise within the scope of the Connecticut Franchise Act and concluded that Nationwide had wrongfully terminated the agency without good cause in violation of the Connecticut statute justifying a $2.3 Million judgment award. While the judgment was eventually reversed three years later on different grounds,[4] it temporarily rocked an industry that had never seriously considered the possibility that insurance agents might be treated as franchisees.[5]

Even the famous clothing manufacturer, Gap International, found itself caught in the franchise snare. In *Gabana Gulf Distribution Ltd. v. Gap International Sales, Inc.*,[6] Gap International authorized a United Kingdom company to distribute its Gap brand merchandise in markets outside the United States, reserving control over the distributor's customers. After Gap decided to change its international distribution strategy and terminated the distribution agreement without cause as permitted by the parties' contract, the distributor sued for wrongful termination claiming the contract was a franchise under California's Franchise Relations Act, which requires good cause in order to end a franchise relationship. The court denied Gap's motion to dismiss the franchise claim early in the case. A year and a half later, the manufacturer finally convinced the court that the distribution arrangement was not a franchise, but not until it was compelled to spend considerable time and resources to defeat the franchise allegation.

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. None of the investors paid cash to the licensor upfront or any type of monthly fee based on gross receipts for the distribution or licensing rights. Certainly none of the licensors expected to end up defending franchise allegations.

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Yet, these situations arise with considerable frequency. Manufacturers, suppliers, and other trademark owners overlook a possible franchise connection when they enter into continuing commercial 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.

Knowledge of federal and state franchise laws may not be enough.[7] Given 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.[8]

Sorting franchises 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 never knew about the law or had no intent to violate it. Not only is it a felony to sell a franchise without complying with franchise sales law,[9] 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.[10] Besides compensatory damages and, in some states, attorney's fees, 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 non-renewal 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.[11] Finally, lawyers who overlook franchise laws may be guilty of malpractice and potentially liable to victims of their client's wrongdoing.[12] 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.[13]

What Is a Franchise?

Most people think they know a franchise when they see one. In truth, franchising is a method of distribution, not a particular industry. There is no uniform definition of a franchise.

As consumer protection statutes, courts give franchise laws a sweeping scope. Consequently, a broad variety of unsuspecting commercial 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 is more broadly described as a "community of interest" (the "marketing plan variation" element).

3) Payment of a required fee (the "franchise fee" element).

A franchise finding hinges entirely on whether a commercial arrangement fits the applicable statutory definition. If any one statutory element is missing from the arrangement, 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.[14] A party cannot avoid a franchise relationship simply by disclaiming its existence.[15] It is immaterial what the parties call themselves.

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 sales law may not qualify under state law definitions, or vice versa. What is a franchise in one state may not be a franchise in all the regulating states in which the franchisor operates.

Business owners and their advisers are not the only ones confused. Irreconcilable legal precedents reflect misperceptions among regulators and the judiciary about the legal concept of a franchise. As a result, legislators, regulators, judges, and practitioners alike all suffer from uncertainty about the exact kinds of commercial arrangements intended to be regulated as franchises.[16]

In advising companies that manufacture and distribute products or services or that license business methods, technology, or trademarks to independent operators, practitioners should, as a preliminary, consider the possibility of unwittingly creating a franchise. In so doing, they should consult the franchise statutes, judicial opinions, and administrative guides of each jurisdiction in which the parties reside or intend to do business before their client offers an opportunity involving an express or implied trademark license or takes steps to modify or end the relationship.

On the federal level, franchises are governed by the Federal Trade Commission rule, which describes three general types of franchises: package, product, and business opportunity franchises.[17] The first two are best known and involve the presence of the three basic elements. The package franchisee adopts the franchisor's business format and identifies its independent operation by the franchisor's trademarks, in exchange for which the franchisee pays the franchisor a fee. The franchisee's operating methods are subject to significant control by the franchisor or, alternatively, the franchisor renders significant assistance to the franchisee in day-

to-day operations. Fast food, convenience stores, and real estate services are examples of package franchises. The product franchisee distributes goods identified by the franchisor's brand manufactured by, or for, the franchisor. The franchisee pays a fee for the distribution rights above the wholesale price of the goods. As with package franchises, the franchisor exercises significant control over, or provides significant assistance to, the franchisee. Automobile and gasoline dealerships and delivery route distributors are examples of product franchises.

The third type, business opportunity ventures, encompasses readily distinguishable lower-cost investments such as vending machine routes and work-at-home programs.[18]

State law franchise definitions largely resemble the FTC rule's package and product franchise definitions in that most also require the combination of the three basic elements.[19] The trademark and fee elements are fundamentally the same as the 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 either omits the marketing plan or the payment of a required fee.[20]

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.[21] 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 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 which consumers readily associated with a particular manufacturer in an exclusive territory.[22]
- A dealer was entitled to identify itself as an authorized dealer of the manufacturer's products in Yellow Pages advertising.[23]
- A distribution agreement imposed a duty to use best efforts to promote the sale of branded products.[24]

- Distributor was required to wear uniforms and add the licensor's logo or name on delivery vehicles or store windows.[25]

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.[26]

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.[27] The court was swayed by evidence showing that a building owner had relied on the brand name in renting space to the licensee to operate a cafeteria in the building, which satisfied the substantial association test.[28]

The Licensor's Dilemma. The fact that an agreement lacks an express trademark license does not prove the trademark element is missing. As noted, a de facto license is part of the rights granted to an independent third party who is authorized to sell branded products or services accounting for more than an insignificant percentage of the third party's overall sales. Since the trademark element's presence may depend on the extent of the licensee's 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 recent *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 does not work for trademark licensors that offer lead generation services or other types of marketing support.

The Marketing Plan Variation Element

A handful of states follow the 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.[29]

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 bear 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.[30]

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 and 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.[31] Consequently, a marketing plan may be prescribed by implication when it is outlined, suggested, recommended, or otherwise originated by the licensor, even when making use of the plan is not obligatory.[32]

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.[33] 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.[34]

- 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.[35]

- 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.[36]

- A promoter promised to provide a marketing plan but failed to deliver on its promise.[37]

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), bur the distinction between the two has never been well articulated.[38] 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.[39]

The Licensor's Dilemma. Because the trademark element of a franchise is so easily established, trademark licensors may be tempted to avoid the imputation of a franchise 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 the reach of 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.[40]

Under federal law, imputation of a franchise relationship can be avoided by following the FTC rule, which requires a minimum payment of $500 or more before or during the first six months of operations.[41] By deferring required payments exceeding $500 for at least six months, a licensor will not be deemed a franchise under federal law even if the licensee signs a non-negotiable, secured promissory note (with no acceleration clause) promising to pay the money after six months. While this exemption offers interesting structuring opportunities for franchises sold in states without franchise laws, it has no counterpart in any state with a franchise sale or relationship law. 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.[42] Most product

distribution arrangements rely on the bona fide wholesale price exclusion to avoid structuring a distributorship or dealership program as a franchise.

In addition, 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.[43]

Finally, to be classified as a required fee, the payment must be made to the licensor or its affiliate, or for its 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.[44] If, by arrangement, the third party pays a portion of the franchisee's payment over to the franchisor, 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.[45]

Nevertheless, confusion persists over when required payments *to a licensor* may be properly considered 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.[46] However, a recent 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 that the retailer purchased from the supplier; 2) the supplier derived no income or profit from the 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.[47] At the same time, payments to a licensor for equipment and other items which need not be purchased from the licensor and which are readily available from other sources should not be classified as franchise fees simply because the licensee decides to purchase 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 franchise *relationship* laws regulating termination, non-renewal, and other substantive conditions of the parties' relationship.[49] As noted, a handful of state franchise relationship laws define a franchise under a two-prong test that omits the franchise fee prong.

The Licensor's Dilemma. 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 its 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 non-inventory 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. If there is no breach of contract by the licensee, the licensor cannot end the relationship absent good cause. Because franchise laws cannot be waived, once a fee is paid anytime during the parties' affiliation, a licensor may be foreclosed from reverting to non-franchise status even if the licensor offers to refund the unintended franchise fee.[51] Efforts to have the licensee waive the franchise laws are unhelpful. Thus, the trademark licensor's dilemma is that, in order to escape franchise regulation, licensors 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, jurisdictions. For example, transfers by franchisees are not regulated by federal or state franchise sales laws if the licensor's involvement in the transfer is confined to approving the buyer's qualifications. Other exclusions and exemptions are unique to a particular jurisdiction, reflecting special local lobbying efforts.[52]

Accordingly, individual statutes must always be checked. For example, the FTC Rule and a few other 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.[53]

Accidental Franchises

Because branding is an increasingly important factor 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 non-franchise licenses and franchises.

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 also 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, and technology licenses should 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. But contract drafters are not without tools. When a license or distribution contract is deliberately structured to avoid a franchise definitional element or takes advantage of a statutory exemption or exclusion, the drafter should express these facts in the contract. While self-serving and certainly not bulletproof, the plain language will certainly aid, and possibly influence, the fact-finder's analysis of the franchise claim.

Structural solutions may save some commercial relationships from the reach of franchise laws, but often they come at the price of sacrificing essential marketing concepts, economic objectives, or competitive opportunities. The regulatory burdens of being deemed a franchisor should be kept in perspective. Numerous franchisors comply with federal and state franchise laws every day and sustain and grow successful and 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 obeying disclosure document delivery rules, and manage franchise relationships while respecting state-laws requiring good cause for termination or non-renewal.

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 about their overall strategic objectives.

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[1] *Gentis v. Safeguard Bus. Sys.*, 60 Cal. App. 4th 1294 (1998).

[2] See, e.g., Chapter II on the Background of Franchising appearing in the Federal Trade Commission's 1979 Statement of Basis and Purpose in which the FTC notes that after California adopted its franchise sales law in 1970, other state legislatures enacted similar forms of franchise regulation.

[3] *Charts v. Nationwide Insurance Co*., 397 F. Supp. 357 (D. Conn. 2005).

[4] Chartschlaa v. Nationwide Mut. Ins. Co., 538 F.3d 116 (2d Cir. Conn. 2008). On appeal, the Second Circuit determined that, because the agent had deliberately failed to schedule the agency agreement as an asset when it filed for Chapter 7 bankruptcy years earlier, the agent had abandoned the franchise claim. Consequently, the Second Circuit did not have to address the substantive issue of whether an insurance agency is a franchise under the Connecticut law.

[5] Unlike other industries, insurance groups did not submit comments to the FTC during public hearings in the 1970s on the FTC Franchise Rule. The insurance industry may have felt back then that its connection to franchising was too remote. However, *Charts* is not the first case in which an insurance agency was alleged to be a franchise. There are at least 8 or 9 reported decisions under different state franchise laws in which an insurance agent raised this claim. *Charts* is the only one to rule for the agent; all of the other reported decisions rejected the franchise claim. The outcome in *Charts* may have to do with Connecticut's franchise statute, which is broader than most because it defines a franchise according to a two-prong definition without regard for whether a franchise fee is paid, a definitional variation discussed further in the text. Since the Second Circuit never ruled that the insurance agency in *Charts* was not a franchise, it would be premature to assume that the franchise issue will not surface again particularly in two-prong states, like Connecticut.

[6] *Gabana Gulf Distribution, Ltd. v. Gap Int'l Sales, Inc.*, 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). In the 2006 reported decision, the court held that the complaint adequately pleaded the existence of a franchise. Gap recovered summary judgment on the franchise issue a year and a half later. The early stage ruling on the pleadings illustrates the nuisance cost of the accidental franchise dragnet.

[7] California has two general franchise laws: the California Franchise Investment Act, CORP. CODE §§31000-31506, and the California Franchise Relations Act, BUS. & PROF. CODE §§20000-20043. Enacted in 1970, the California Franchise Investment Act was the first law of its kind to require franchisors to make presale disclosures and register with a state agency before offering or selling franchises in the state. Other jurisdictions later modeled their franchise sales laws after California's, although, overall, little regulatory uniformity exists. California enacted the California Franchise Relations Act in 1980, requiring franchisors to have good cause to terminate, not renew, or cancel a franchise.

[8] Franchise sales in the U.S. are subject to dual regulation at the federal and state level depending on where the parties reside or intend to do business. The federal franchise sales law, originally adopted in 1978 and overhauled for the first time in 2007, regulates franchise sales in all 50 states, including wholly intrastate transactions, and requires presale disclosure, out not registration with a federal agency. 16 C.F.R. §§436 (2007) [hereinafter Amended FTC Rule], 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. Oregon's franchise sales law does not require registration with a state agency but does mandate disclosure and certain record-keeping duties. The Amended FTC Rule supplements state franchise sales laws but does not preempt them. Roughly half the states also have franchise relationships laws comparable, but not identical, to California's.

[9] CORP. CODE §31410 ("Any person who willfully violates any provision of this law...shall upon conviction be fined not more than one hundred thousand dollars ($100,000) or imprisoned in the state prison, or in a county jail for not more than one year or be punished by both....).

[10] There is no private right of action for FTC rule violations, which only the FTC may enforce. However, private parties may have remedies under state unfair trade laws based on FTC rule violations.

[11] *Spahn v. Guild Indus. Corp.*, 94 Cal. App. 3d 143 (1979).

[12] See *Courtney v. Waring*, 191 Cal. App. 3d 1434 (1987). See also Alexander M. Meiklejohn, *UFOCs And Common Law Claims Against Franchise Counsel For Negligence*, 25 Franchise L.J. 45 (Fall, 2005).

[13] See e.g., *Coyne's & Co. v. Enesco, LLC*, 565 F. Supp. 2d 1027, 1049 (D. Minn. 2008) (allegation that payment was an indirect franchise fee under Minnesota franchise law required fact-specific inquiry not appropriate on a

motion to dismiss); *Budner v. Wellness Int'l Network, Ltd.*, 2007 U.S. Dist. LEXIS 18256 *37 (N.D. Tx. 2007) (Illinois' sweeping franchise definition prevented early dismissal of franchise law claim).

[14] The FTC rule excludes purely oral agreements from its franchise definition, but most state franchise definitions apply to oral and written contracts.

[15] *People v. Kline*, 110 Cal. App. 3d 587 (1980) (partnership agreement held to be franchise)

[16] Stephen C. Root, *The Meaning of "Franchise" under the California Franchise Investment Law: A Definition in Search of a Concept*, 30 MCGEORGE L. REV. 1163, 1188 (1999). Authors have examined franchises from different angles. Sales agency relationships may qualify as franchises. John R. F. Baer and Scott P. Weber, *When Are Sales Representatives Also Franchisees?,* 27 Franchise L.J. 151 (Winter 2008). Franchise status does not preclude a finding that the franchisor is also the franchisee's employer. Dean T. Fournaris, *The Inadvertent Employer: Legal And Business Risks Of Employment Determinations To Franchise Systems*, 27 Franchise L.J. 224 (Spring 2008).

[17] Federal Trade Commission, Compliance Guides, 72 FR 15444 (March 30, 2007).

[18] California regulates "seller assisted marketing plans," arrangements comparable to business opportunities, under the Contracts for Seller Assisted Marketing Plans, which has its own disclosure and registration requirements. CIV. CODE §§1812.201-1812.221.

[19] California's franchise definition is a fairly typical three-prong definition, although it is somewhat broader in scope than other three-prong definitions in that it expresses the right to offer, sell, *or* distribute goods or services, in the disjunctive. *Gentis v. Safeguard Bus. Sys.*, 60 Cal. App. 4th 1294, 1300 n.1 ("By using the word 'or,' the Legislature intentionally broadened the scope of the statute.")

[20] Arkansas, Connecticut, Delaware, Missouri, Nebraska, New Jersey, Wisconsin, Puerto Rico, and the U.S. Virgin Islands have franchise relationship laws that define a franchise without reference to payment of a required fee. An article addressing Connecticut's franchise law concludes that the lack of a franchise fee requirement in Connecticut's definition is not sound reason for extending Connecticut's law to business arrangements not typically thought of as franchises based on policy reasons that might also apply in other two-prong states. See Note: *The Connecticut Franchise Act: How Important is the Absence of a Franchise Fee Requirement in the Connecticut Franchise Act?*, 25 Quinnipiac L. Rev. 663 (2007).

[21] The California Department of Corporations, which oversees the California Franchise Investment Law, elaborates on California's franchise definition in often-cited 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: "Therefore, if 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." Other jurisdictions have cited Release 3-F to interpret their own statutes. As noted, California's franchise law has served as a model for both the FTC and other states in adopting their own franchise regulations. Release 3-F has been cited favorably by the FTC, other state franchise agencies, and courts outside of California in interpreting their own franchise laws. See, e.g., FTC Informal Staff Opinion dated October 9, 1980 issued to U.S. Marble, Inc., which appears in CCH Business Franchise Guide ¶ 6424 (October 9, 1980) and *Twin Cities Galleries, LLC v. Media Arts Group, Inc*., 476 F.3d 598, 602 (8th Cir. Minn. 2007).

[22] *Lobdell v. Sugar 'N Spice*, 658 P. 2d 1267 (Wash. App. 1983).

[23] *American Bus. Interiors, Inc. v. Haworth, Inc.*, 798 F. 2d 1135 (8th Cir. 1986).

[24] *Cassidy Podell Lynch, Inc. v. Snyder Gen. Corp.*, 944 F. 2d at 1139 (3d Cir. 1991)

[25] *Cooper Distrib. Co., Inc. v. Amana Refrigeration, Inc.*, 63 F. 3d 262, 272-73 (3d Cir. 1995).

[26] There is no universally recognized *minimum* percentage of branded product sales that qualifies as a "substantial association" with a supplier's trademark. The FTC rule, California, and a number of other states have their own version of an exemption for "fractional franchises," defined generally as multiline distributorships in which sales of any one brand make up less than 20% of the distributor's total sales. States lacking this exemption do not construe "substantial association" uniformly or necessarily view 20% as a minimal threshold.

[27] *Kim v. Servosnax, Inc.*, 10 Cal. App. 4th 1346 (1992).

[28] However, in the Gabana Gulf case mentioned in the text, a federal district court narrowed the earlier California appellate decision by holding that it is not enough for a licensee to deal exclusively in a licensor's branded products. Like the earlier case, Gap forbade Gabana from using Gap's marks without Gap's prior written approval. Because Gabana could not show that its customers associated Gabana with Gap and not just with Gap brand merchandise, the court concluded the trademark element was missing and the relationship was not a franchise. In an effort to reconcile its decision with the earlier one, the court explained that, while the building owners there had initially selected the franchisor to set up the cafeteria and provide an operator to run it, Gap was not responsible for leading Gabana's customers to Gabana. The distinction seems thin: Gabana had exclusive distribution rights to the Middle East so any retailer in the area wanting to sell Gap brand merchandise did not need Gap to direct them to Gabana. Rather than illuminate the substantial association standard, Gabana Gulf obscures it, leaving the definitional analysis murky and uncertain.

[29] Release 3-F, *supra* note 21.

[30] Release 3-F, *supra* note 21, provides a comprehensive explanation of the individual components of the marketing plan element and identifies numerous factors indicating a marketing plan.

[31] Release 3-F, *supra* note 21.

[32] *Id*.

[33] Steven D. Wiener, *Gentis v. Safeguard Business Systems, Inc.*, Liberal Construction of Remedial Statutes: What Is a Franchise?, 17(4) FRANCHISE LJ. 115 (1998).

[34] *Boat & Motor Mart v. Sea Ray Boats, Inc.*, 825 F. 2d 1285 (9th Cir. 1987).

[35] *Meadow Fresh Farms, Inc. v. Sandstrom*, 333 N.W. 2d 780 (N.D. 1983).

[36] *Carlos v. Philips Bus. Sys., Inc.*, 556 F, Supp. 769 (E.D. N.Y. 1983), *aff'd in part and rev'd in part*, 744 F. 2d 287 (2d Cir. 1984).

[37] *People v. Kline*, 110 Cal. App. 3d 587.

[38] Whether know-how controls, such as those common to patent licenses, are enough to turn a nonfranchise license into a franchise may depend on whether the know-how affects just an aspect of the licensee's operations, e.g., production) or are more pervasive.

[39] See, e.g, *Instructional Sys., Inc. v. Computer Curriculum Corp.*, 826 F. Supp. 831 (D. N.J. 1993)

[40] Amended FTC Rule, §436.2(a)(2); Release 3-F, *supra* note 21. The fees pay be bundled and therefore buried in charges for goods or services. See *Lobdell v. Sugar 'n Spice*, supra note 22 at 892.

[41] Amended FTC Rule, §436.2(a)(3)(iii).

[42] *Boat & Motor Mart v. Sea Ray Boats, Inc.*, 825 F. 2d 1285 (9th Cir. 1987).

[43] Release 3-F, *supra* note 21. See *Day Distrib. Co. v. Nantucket Allserve, Inc*., 2008 U.S. Dist. LEXIS 57334 (D. Minn. July 25, 2008) (co-op marketing payments to the supplier were ordinary business expenses and not payments for *the right to remain a distributor* where facts showed that not only did distributor have right to opt-out of participating in the supplier's marketing programs, it had opted out a number of times).

[44] *Thueson v. U-Haul International, Inc*., 2006 Cal. App. LEXIS 1736 '12 (2006). The California Court of Appeal, finding no published California authority directly explaining what constitutes a "franchise fee" seized the chance to explain California law on the subject even though the discussion is unnecessary to the holding. The California court, following *Wright-Moore Corp. v. Ricoh Corp.*, 908 F. 2d 128 (7th Cir. 1990) (Indiana law), explained that a "franchise fee" requires a "firm-specific investment in the franchisor," in contrast to payments for ordinary business expenses, although it shed no light on when a payment to a licensor is, and is not, a firm-specific investment. The U-Haul facts, however, showed that the dealer had made no payments at all to U-Haul. Rather, U-Haul had deducted from the dealer's rental commissions expenses for the dealer's use of a local telephone line, directory listing, and local computer terminal. The U-Haul decision, 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. Appx. 2 (9th Cir. 2005).

[45] See, e.g., *Wright-Moore Corp. v. Ricoh Corp*., 908 F. 2d 128 (7th Cir. 1990).

[46] Release 3-F, *supra* note 21.

[47] *R&A Small Engine, Inc. v. Midwest Stihl, Inc.*, 2006 U.S. Dist. LEXIS 92208 (D. Minn. 2006). Not only does the Minnesota decision seem at odds with precedent in other jurisdictions, but it offers no bright line for distinguishing payments *to a licensor* as ordinary business expenses from payments for the right to use the licensor's marks.

[48] See, e.g., regulations under the Illinois franchise law which exclude from the definition of a franchise fee payments made to a franchisor or affiliate for equipment, materials, real estate services, or other items when the franchisor permits the franchisee to purchase the items from sources other than the franchisor or its affiliates and the item is available from such other sources. Reg. 200.105 to the Illinois Franchise Disclosure Act, 815 ILCS 705/1-44 (1999). See also *Hamade v. Sunoco, Inc*., 271 Mich. App. 145, 163-64 (Mich. Ct. App. 2006) (a franchise fee requires a transfer of wealth; therefore, repayment of loan was not a franchise fee absent proof of above fair market value interest rate.)

[49] See *supra* note 20.

[50] *Sports Racing Servs. v. Sports Car Club of Am.*, 131 F. 3d 874,891 (10th Cir. 1997) (Indiana law).

[51] The California Commissioner of Corporations interprets a franchise fee to include 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. Nothing in California's statute suggests that an outcome like *To-Am* could not happen in California, which defines a franchise similarly to Illinois. If any required payment to a supplier over California's minimum ($100 per year for fees and $1,000 per year for fixtures, equipment, or other tangible property) is enough to create a franchise in California, then a distribution or licensing program that is not a franchise at inception for lack of a required payment could become a franchise once required payments exceed the minimum in any year. The idea that a nonfranchise agreement could turn into a franchise sometime after the parties execute a contract adds an entirely new level of uncertainty to the status of licensing and distribution arrangements. For additional discussion, generally, on what is a franchise fee, *see* "point/counterpoint" articles by Jonathan Solish, *Unrecoverable Investments Are Critical*, 26 FRANCHISE L.J. 1 (2006) and Bruce Napell, *State Relationship laws Are Not Uniform*, 26 FRANCHISE L.J. 1 (2006).

[52] For example, only Minnesota exempts burglar alarm franchises and arrangements between local and national airlines carriers.

[53] CORP. CODE §31108.

[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).