The Accidental Franchisor

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When you are representing the expansion-minded client, you have three jobs: spare no effort to keep the client away from the intricacies of franchise law; consult a franchise lawyer when in doubt; and hope that no dispute arises in the that will turn the client into an accidental, unwilling franchisor anyway.

ENTREPRENEURS, like children on the sidewalk outside an ice cream shop on a summer's day, are hopeful folk. They see any solid uptick in the economy as cause to start thinking expansion — and they can bring big-time trouble down on their heads if expanding means doing licensing, dealership, or distribution deals.

Why? Because those who step over a fine line separating many ordinary business arrangements from franchising operations may find themselves unhappily enmeshed in an intricate regulatory apparatus whose dictates govern virtually every aspect of the entrepreneur's business operations. In a worst-case scenario, a misstep can drag the entrepreneur into court to fight state or federal regulators hoping to make the entrepreneur do some jail time, not to mention angry business associates seeking to rescind their deals and maybe collect damages.

To be sure, life rarely gets that hard for the accidental franchisor; as a rule, to do jail time, you have to commit big-time franchise fraud. But franchising is a growth industry, and many an expansion-minded entrepreneur has gone down the franchising road to success. Many others, however, cobble together what they believe to be licensing arrangements or distribution or dealership systems involving trademarked goods or services only to find that, in the eyes of the law, the arrangements look and smell like franchise arrangements.

That can spell trouble, because franchising is not for the faint-hearted. Indeed, the entrepreneur who thinks government regulates private industry with a heavy hand has another think coming once he or she becomes a franchisor. Government doesn't much care what companies do in forming ordinary business relationships. It cares a great deal, on the other hand, about the business dealings of franchisors, whom it generally considers bad guys on the prowl for good guys, otherwise known as franchisees. To keep them at bay, government requires franchisors to prepare and register complex and costly franchise disclosure documents before they can begin to sell franchises, for example, and it strictly regulates much of their business activities thereafter.

This makes it the job of the business lawyer to draft licensing, distribution or dealership agreements for expansion-minded clients that remain exactly that — meaning arrangements that do not establish the franchisor-franchisee relationship under either state or federal law — if that is possible. In addition, since knowledgeable franchise law attorneys have attempted for decades, without much luck, to draft the "Not-A-Franchise" License Agreement when the client's business structure includes all of the elements of a franchise under the law, it is also the business lawyer's responsibility to explain to these clients that in such cases, franchisor-franchisee avoidance is just not possible..

KNOW IT WHEN YOU SEE IT • The first step in getting the job done is to understand what constitutes a franchising arrangement, and what distinguishes a franchising arrangement from other ordinary business relationships. Start with the Federal Trade Commission's definition of a franchising arrangement, which, boiled down, seems simple enough. A franchising arrangement, the FTC says:

- Grants permission to use a trademarked good or service in the conduct of a business enterprise;
- Requires the payment of royalties to the trademark owner;
- Gives the trademark owner significant control over the operations of the business making use of the trademark, and
- May obligate the trademark owner to provide significant assistance — for example, training — to the business making use of the trademark.

State laws take a more specific tack, generally defining a franchisor-franchisee relationship as one in which:

- The franchisee pays a franchise fee to the franchisor plus royalties and possibly payments for inventory, supplies, training, and assistance in order to gain the right to sell or distribute trademarked goods or services under a marketing plan "prescribed in substantial part" by the franchisor;
- The franchisor exercises significant control over the franchisee's business, grants the franchisee exclusive rights to operate in a given territory, and may require the franchisee to purchase or sell a specified quantity of the franchisor's goods or services; and
- The franchisee's business is "substantially associated" with the franchisor such that, for example, the franchisee uses the franchisor's trademark and advertising slogans to identify its business.

These points make clear why many expansion-minded entrepreneurs get into trouble when negotiating licensing, distribution, or dealership agreements. After all, if you don't have the resources to expand by buying up other companies outright, you need to get their owners to buy into your plans, and that can mean allowing them to use your trademark, granting them territorial rights, helping them with training and perhaps technical assistance, and keeping tabs on them to ensure that all of your work turns into dollars on your bottom line — and if you go too far down this road, you turn into a franchisor.

That brings us back to the lawyer's job, which is to keep exactly that from happening — if you can.

The key to the franchisor-franchisee relationship is that it makes one party, the franchisee, dependent on the other, the franchisor, for many of the elements of a successful business enterprise — for example, a valuable and widely known trademarked product or service, an efficient and proven business system, expert advertising, marketplace dominance, and the like. These elements create value, and franchisees pay good money to make use of them in the form of franchise fees and royalties.

By way of contrast, ordinary licensing, distributorship or dealership arrangements do not make one party dependent on the other; indeed, the hallmark of such arrangements is that the parties come to the negotiating table as independent business operations and remain so, each with its own product or service, whether trademarked or not, and each with its own business systems, advertising and marketing strategies, and the like. One or both of the parties may indeed make use of the other's trademarked goods or services under such arrangements. They may collaborate in advertising and marketing campaigns, in training employees to make the most of the relationship, and even in developing business systems to keep track of successes and failures. To be sure, money will also change hands, but it will not take the form of royalties — that is, the regular payment by one party to the other of sums reflecting a specific percentage of gross sales. Instead, when money changes hands among parties to licensing, distributorship or dealership agreements, it is usually payment at wholesale prices for goods or services for resale.

The parties to such arrangements, in short, do business together, but they do business on their own, too, and remain separate and independent enterprises.

KEEPING ENTERPRISES SEPARATE • It follows from the above that the lawyer who helps a client to come to any such arrangement must make sure that the contracts documenting the deal do not inadvertently take the client into the world of franchising.

How? Words are important — though not, as we shall see, always dispositive when it comes to the vagaries of franchise law — so let's start with the language in contracts covering, say, a licensing arrangement of a trademarked good or service. The language in such contracts must assert that the arrangement is a licensing agreement only and that the parties do not intend to create a franchisor-franchisee relationship.

Should the arrangement require that the licensor provide training services — a common hallmark of franchisor-franchisee agreements — the contracts must specify who is to do what, and at what cost. Similarly, should the contracts set up the licensor as the sole provider of trademarked goods or services to the licensee — another common hallmark of the franchisor-franchisee relationship — they must provide that the licensor will offer the goods or services at bona fide wholesale prices only and that the licensor may impose no obligation on the licensee to purchase goods exceeding the supply deemed necessary by the licensee.

Getting the right language into the contracts, however, is not enough. Indeed, it may not matter at all what the contracts say about trademarked goods or services, or about licenses and fees, if the actual business practices of the parties mimic those of franchisors and franchisees. As this makes clear, the control issue is particularly important. If a licensing agreement, for example, imposes only specific limitations on the way the licensee may advertise a trademarked good or service, then the licensor must refrain from trying to impose others — or else re-negotiate the contract.

Put another way, if the parties to a licensing agreement get into a tussle over the way the licensee advertises a trademarked good or service, the courts will surely want to know the extent to which the licensor dictates how the licensee uses the asset in the course of business — and if they find elements of a franchisor-franchisee relationship in the practices of either or both parties, they will probably rule the agreement a franchisor-franchisee arrangement.

Clearly, the object of the game for the business lawyer who writes any such agreement is not just to specify that the parties to the agreement do not contemplate creating a franchisor-franchisee relationship even though one may offer training services or they may, in one way or another, do business in training services or become the sole supplier of trademarked goods. The parties must avoid creating a de facto franchisor-franchisee relationship in practice, and it is the job of the lawyers involved to help them understand what is possible and what is not. The contracts the lawyers write may specify that the parties intend to remain independent, but they must remain so in practice, too.

The lawyer who crosses t's and dots i's in any such arrangement keeps trouble away in more ways than one. There is, of course, the state regulatory apparatus, along with its worries about bad-guy franchisors. There is also the erstwhile business associate who, unhappy with the results of a licensing, dealership, or distribution deal, seeks redress in court on grounds that the contracts documenting the arrangement really established a franchisor-franchisee relationship and that, as an injured franchisee, he or she has dibs on a certain pile of treasure.

BEYOND THE LABELS • We all know that in a litigious age, there is pretty much no claim to which an unsuccessful venture cannot give rise, and the complexities of franchise law give rise to their share. Take, for example, the dizzying case of a South Carolina distributor of rain gutters whose manufacturer sued for "royalties" allegedly due under a licensing agreement. In response, the distributor argued that if indeed the licensing agreement called for the payment of royalties, the arrangement was really a franchising agreement and the manufacturer had violated the state's Unfair Trade Practices Act law by failing to provide the manufacturer with a franchise disclosure document.

The state court disagreed, ruling that the arrangement was what the contract called it — namely, a licensing deal — but things didn't end there. The dispute reached the South Carolina Supreme Court and even, at one point, federal district court, which noted that what mattered was not what the contract said but what the relationship between the manufacturer and the distributor amounted to — and it was "problematic," the court added, whether the relationship in this instance amounted to a franchisor-franchisee relationship. *Englert, Inc. v LeafGuard USA, Inc.,* 2009 U.S. Dist. LEXIS 116106, Bus. Franchise Guide (CCH) ¶ 14,297 (D.S.C. Dec. 14, 2009).

The manufacturer and distributor eventually settled their dispute out of court, but not before learning that it costs time and money to get free of the intricacies of franchise law.

On a more positive note, another case, this one involving what it means to be a franchisee, shows that common sense can prevail, more or less, though once again at the cost of time and money. A Michigan insurance agent sued an insurer complaining that as a condition of entering into an "Independent Contractor Agent's Agreement," the carrier had required him to borrow $15,000 from a bank owned by the carrier to buy furniture and computers and to follow specific marketing programs and growth strategies in the conduct of his business. *Bucciarelli v. Nationwide Mutual Insurance Co.,* 662 F. Supp. 2d 809, Bus: Franchise Guide (CCH) ¶ 14,200 (E.D. Mich. 2009).

The label on the contract didn't matter, the agent argued. The $15,000 amounted to a franchise fee, and that plus the requirement that he follow specific marketing programs and growth strategies established a franchisor-franchisee relationship between him and the carrier.

Nothing doing, said the insurer. Michigan franchise law does not cover insurance agents, and even if it did, the $15,000 was a loan, not a franchise fee. Indeed, the agent couldn't be a franchisee at all because he really didn't sell insurance products, the insurer argued. He was really just an "order taker" of insurance products, and the insurer did not require him to follow "a marketing plan or system prescribed in substantial part" by the insurer.

The insurer won the day in this case, but the court left the door open on the question whether Michigan franchise law might indeed cover insurance agents, no matter what label insurers put on their agent contracts.

CONCLUSION • Courts across the land have left doors open on other fuzzy questions under franchise law. Indeed, franchise case law abounds with cases seeking to blur the distinctions between ordinary business arrangements and franchising agreements, and as time goes on, the good bet is that the line separating the two, already fine, will become even finer. It follows that for the business lawyer preparing any such agreement, Job One is to spare no effort to keep the expansion-minded client safely away from the intricacies of franchise law, if it is possible to do so. Job Two is to consult a franchise lawyer when in doubt. Job Three is to hope that no dispute arises in the ordinary course of business that will turn the client into an accidental, unwilling franchisor anyway.