

Franchise Operations Must Conform to Special Laws

Even If the Parties Believe They Are in Another Form of Business Relationship

By Barry Kurtz

When is business enterprise a franchise operation? What's the difference between a franchise and a licensing arrangement, a distributorship, or a dealership?

Countless numbers of entrepreneurs confuse the meaning of these terms, and because serious and potentially painful consequences can follow for companies not adhering to complex areas of both federal and state franchise law, PNG members should understand these differences when counseling their clients.

In plain English, some business relationships may in fact be franchise arrangements even if the parties intend to establish some other kind of relationship, and if they aren't careful, they may wreck their enterprise.

Under California law, a franchise exists between the owner of an identifying trademark and the operator of a business using the trademark when:

- * The franchisee engages in offering, selling or distributing goods or services under a marketing plan or system "prescribed in substantial part" by the franchisor;
- * The franchisee's business is "substantially associated" with the franchisor; and
- * The franchisee pays a fee to the franchisor or to an affiliated party, directly or indirectly, in order to

engage in business. The first of these conditions exists when the franchisor:

- * Provides the franchisee with advice and training;
- * Retains significant control over the conduct of the franchisee's business;
- * Grants the franchisee exclusive territory; or
- * Requires the franchisee to purchase or sell a specified quantity of the franchisor's goods or services.

A simpler test determines whether the franchisee's business is substantially associated with the franchisor: If the former uses the latter's trademark to identify its business, it is substantially associated with it.

As for fees, they include payments made by a franchisee directly to a franchisor when signing a franchise agreement and payments made indirectly such as those for training and assistance, royalties, or inventory.

Business relationships that do not satisfy these conditions may be licensing arrangements, distributorships, dealerships, or any one of a variety of other business arrangements, but the distinctions between these arrangements and franchise operations are subtle and sometimes treacherous.

For instance, a licensing arrangement exists when an independent business operating under its own trade name undertakes to sell products manufactured by a trademark owner and pay the manufacturer a percentage of the sale proceeds. Dealerships and distributorships exist when an independent business operating under its own trade name purchases — typically at wholesale prices

— and resells the products of a manufacturer or supplier, with minimal interference by the latter.

In such cases the key is not whether the business entities entering into the arrangement intend to establish a specific relationship — for example, a distributorship rather than a franchise. The key is rather whether they operate independently, even though one buys and sells goods produced by the other under a trademark.

The relationship between franchisor and franchisee, by way of contrast, is a dependent one, as evidenced by the arrangements regarding marketing, training, and the like.

In the real world of business, of course, such distinctions are not always apparent, and any business entity that grants another the use of a trademark may unwittingly stray over the line and establish a franchisor-franchisee relationship in the eyes of the law.

When this happens, the franchisor must observe many details of state law that do not apply to companies establishing licensing or other business arrangements, on pain of substantial civil, administrative, and even criminal penalties.

Franchisors must, for example, get the approval of the state Department of Corporations for any uniform franchise offering circulars they propose to use in this state, and they must give prospective franchisees at least ten business days to study the offering circular and any attendant contacts before signature.

They must also get the department's approval for any "material modifications" they propose to make to existing agreements before presenting them to franchisees. Material modifications may include new provisions reducing or enlarging the rights or obligations of either franchisor or franchisee, including new or increased royalties or fees or rights to engage in internet commerce.

Many of these are bureaucratic burdens; the Department of Corporations seeks to police aggressive franchisors, but it typically does not withhold approval. It does require

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Managing Directors Column Déjà Vu — All Over Again

By Gordon W. Gregory and Davis R. Blaine

A revolution is underway, drawing us back to our roots. Once upon a time, PNG was a deal clearing house. Our members were senior bankers, transaction attorneys, accountants and investment bankers, and our purpose was to put deals together, our deals. Buyers and sellers, as well as lenders and borrowers, were brought together by their trusted advisors. We advanced the interests of our clients and we, as the advisors, made our professional fees.

Then, professionals addressing other vital needs of our middle market clients, as well as the wealthy, joined us and produced a chemical reaction — the essence of PNG. What is this essence? It is the power of collaboration, the creation of a culture of caring and sharing. And not only about each other,

but a sincere concern about clients and client service. So what's not to like?

Our preoccupation has been about the culture, the peer level friendships and professional relationships which have blossomed. This we want to continue to embrace, wholeheartedly. But we need to bring back into balance culture and commerce. PNG provides an opportunity to build deep, valuable relationships with other rainmakers and value creators. In fact, it is designed so that any member can become a gateway for their clients and colleagues to the many unique talents, disciplines and resources within our ranks.

The concern most often expressed is about member quality and relevance. Does a member presently serve in a trusted advisor capacity with owners, senior executives, and the wealthy? What is the periscope level of the client or market served? What are the

type and frequency of referrals made? What is the size of the client base? What unique talents, experience, information and contacts does the member possess? How does the member produce value for the other members of his or her group? Does the member actively participate in his or her group?

In order to drive the value of membership, we need to drive more business to and among our members. To do this will require three things: first, that we raise the standards of membership; second, that each of us take on the responsibility of recruiting new stars and rainmakers to PNG; and third, that each of us commit to becoming a star or rainmaker.

Our commitment is to raising the high bar. We sincerely appreciate your support, cooperation and assistance in taking PNG to the next level.

CA BUSINESS

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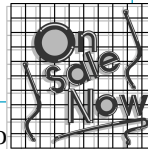
to expanding their businesses. There are over 30 SBDC offices throughout California, seven in the LA area. Although this program is funded almost entirely by the federal government, the governor's budget proposes to cut it significantly.

[Part two of this article, which is posted as a knowledge document on www.provisors.com, describes additional tax, financing, training, and consulting programs available primarily to California manufacturing, distribution, and wholesale companies.]

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PLAN BEFORE YOU SELL

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leverage of almost 5 to

Simply by engaging in estate planning before they sell their businesses, business owners can leverage their lifetime exemptions (\$1 million and growing) by 50% or more. Shouldn't every business owner work with an estate-planning attorney to take advantage of this unique opportunity?

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that franchisors clearly disclose the impact of any material changes so that franchisees understand them.

As you may surmise from all this, state law presumes that in the relationship between franchisor and franchisee, the former has the advantage, and it goes to great lengths to protect franchisees. It follows that companies establishing franchise operations must step carefully — a good thing for PNG members to know when advising clients who themselves may not understand the impact of their actions.

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