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**What Every Lawyer Should Know about
Franchise Law**

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What Every Lawyer Should Know about Franchise Law

Too often, expansion-minded business owners opt for a strategy offering trademarked products or services through licensing arrangements or distribution or dealership systems only to discover, well into the game, that what they have really done is turn themselves into franchisors—"accidental franchisors," maybe, but franchisors nonetheless.

This is good news for the entrepreneur who runs a sophisticated business operation capable of meeting the many punctilios of California franchise law. It is bad news for the entrepreneur who doesn't. In fact, it can spell disaster for the unwitting entrepreneur who steps over the fine line that separates franchising from other commercial arrangements involving trademarked goods or services.

1 California law defines a franchisor as one who offers, sells, or distributes trademarked goods or services through one or more "substantially associated" business enterprises following a marketing plan "prescribed in substantial part" by the franchisor in exchange for fees collected directly or indirectly from the associated business enterprises. The second of these phrases is self-explanatory. But what does "substantially associated" mean? The test is simple. If a business enterprise uses the trademark of another company to identify its business, it is "substantially associated" with it under the eyes of the law.

But there is more to the story. A business also may be a franchisor if it allows another business to use its trademark and it also:

- Provides the other business with advice and training as to the sale of its products or services,
- Exercises significant control over the conduct of the other business,
- Grants the other business exclusive rights to sell its products or services in specific territories, or
- Requires that the other business purchase or sell specific quantities of its products or services.

Unfortunately, expansion-minded entrepreneurs may seek to institute one or another of these practices when negotiating licensing or distributorship or dealership arrangements with other companies. This makes it crucial for attorneys involved in setting up any such arrangements to determine whether the practices push the relationship between the companies into the realm of the franchisor and franchisee.

2 One key to determining the character of the relationship is the independence of the two enterprises. In the eyes of the law, the contractual arrangements between franchisors and franchisees make the latter dependent on the former. Franchisees sell or distribute the trademarked products or services of franchisors, usually in exclusive territories—that is, territories in which the franchisor will not permit other franchisees to operate. They also rely on franchisors for advice, training, and advertising and marketing assistance. In some cases, franchisors may serve as exclusive suppliers of the products or services sold by its franchisees.

3 Licensing and distributorship or dealership arrangements, on the other hand, are relationships between independent companies, each operating under its own trade name, and each largely uninvolved

in the operation of the other. Thus, under typical licensing arrangements, one company permits another to sell its products or services in exchange for a percentage of the proceeds, with no other involvement in the affairs of the other company. Under typical dealership or distributorship arrangements, a company operating under its own name undertakes only to buy the products or services of another at wholesale prices for purposes of resale, once again with minimal involvement of either company in the affairs of the other.

4 The state exercises little or no oversight over licensing, distributorship, or dealership arrangements; however, it exercises a great deal of oversight over franchisors and franchisees. It is precisely because the state does so that attorneys must make sure their expansion-minded client companies do not step over the line into franchising inadvertently. If that happens, companies must take on burdens not imposed on firms entering into licensing, distributorship, or dealership arrangements. Among other things, franchisors must:

- File franchise offering circulars with the Department of Corporations outlining the franchising opportunity in detail along with the franchisor's own background and business experience, among other matters, before entering into any discussions with potential franchisees, and
- Obtain Department of Corporations approval for any "material modifications" they want to make to existing franchise agreements before presenting them to franchisees, including any new or modified provisions regarding royalties, fees, Internet commerce, and territory rights.

5 The Department of Corporations closely polices franchisor-franchisee arrangements, and it has authority to assess penalties of \$2500 per violation on companies operating in violation of the many details of franchise law. Even here, however, there is more to the story. Suppose that a company enters into arrangements with half a dozen other companies involving trademarked products or services, unaware that the details of the arrangements establish franchisor-franchisee relationships. At some point, the first company discovers its error but, having profited by the arrangements, decides that it really wants to be a franchisor after all.

Before it can square things with the Department of Corporations, it must give its half dozen inadvertent franchisees the right to rescind the original arrangement and get their money back—meaning not only their original investment but also any losses they may have incurred less any profits. This can prove painful, even ruinous to the inadvertent franchisor.

Clearly, the better idea is to avoid the pain. Franchising is a complex business, and although it can prove a highly effective expansion strategy, entrepreneurs must know beforehand whether the arrangements they enter into with other firms do or do not constitute franchisor-franchisee agreements—and if so, of course, whether this is what the parties want.

—Submitted by Barry Kurtz, of counsel to the Encino law firm of Greenberg & Bass. Kurtz specializes in franchise law.