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Spotting an Accidental Franchise (and Why It Matters to You)

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Imagine you own a successful business with retail locations in several Southern California cities offering desserts in a unique fun-filled party atmosphere operating under the name Dessert Dreams. A Chicago investor vacationing with his family visits one of your locations and enthusiastically proposes entering into an agreement with you to help you open locations in Illinois and a location near his brother-in-law's home in Northern California. He offers to pay $20,000 per location, as well as ongoing royalties for the right to use your business name and system of operation. He tells you he is ready to move forward, but has a meeting scheduled with his partner at a conference in New York and asks you to send him the agreements there.

This all seems like a dream come true. You do not have the time or resources to expand to Northern California, let alone out of state. Licensing the concept to a responsible partner in a remote venue represents "found money" to you. To the businessman from Chicago, it also represents a great deal because he does not have to protect a trademark or develop and test a business concept, yet has seen that the model works and can be successful.

Everyone wins, right?

Not so fast. You are about to violate franchise laws in California, Illinois and New York, all of which require registration of franchise offerings. You are also about to run afoul of the requirements of federal law mandating pre-sale franchise disclosure.

This scenario comes up with alarming frequency in a multiplicity of industries. What it represents is a minefield of potential liability for "licensors" who have inadvertently crossed the legal line into franchising. It does not matter what label an agreement is given – license, partnership, consultancy. The *only* issue is whether the transaction includes all of the elements of a franchise. Despite this, many business people, and even lawyers, mistakenly believe that a "license" is not a franchise. This error can come back to haunt a business. Ironically, the more successful the license network is, the bigger the problem.

So, what exactly is a franchise? To some extent, the answer to this question depends on your location. Here in California, there are three elements that determine whether a business is a franchise and therefore subject to franchise laws.

- Substantial association with the franchisor's name or commercial symbol
- A marketing plan prescribed in substantial part by the franchisor
- Payment of a fee

Name/Symbol

Federal law makes clear that if the use of the name of the system is prohibited, an agreement is not a franchise. Although this seems pretty straightforward, California courts have made it less so. For example, the court in *Kim v. Servosnax* found this element present even though the grantor prohibited the operator from using its name. The business was a corporate cafeteria and food-service operation. Patrons dining at the facility had no indication that the business was being operated by a third party pursuant to an agreement with Servosnax using its operational system. The court noted that the facility owner, on the other hand, was very familiar with the Servosnax brand and system and knew that the cafeteria operator was operating under a license from Servosnax. Therefore, it concluded that the ultimate public consumer may not be the audience to whom the name is communicated. It may be another party, such as the facility owner in this case.

Marketing Plan

This element of the definition is very fact-driven and is actually broader than merely providing marketing or advertising materials to the franchisee. It can also include site-selection requirements, control over terms of payment by customers, credit practices, warranties and representations to customers, operations manuals, territorial allocations, specifications and standards and, indeed, anything that contributes to creating a customer impression of centralized management and uniform standards. Because California was the first state to enact a franchise law, a number of states that followed also adopted this element in their definitions of a franchise. Other states chose a different standard – the parties need only have a community of interest in the business.

The federal version of the element is a bit different. If the licensor agrees to provide significant assistance in the operation of the business or can exert significant control over that business' operation, this element of the definition is present.

Payment of a Fee

Any fee to enter into the agreement may qualify as a franchise fee. Of note, however, is the fact that the requirement to purchase goods at bona fide wholesale purchase prices for resale does not constitute a franchise fee, assuming that there is no requirement to purchase more than a reasonable businessperson would purchase for inventory.

California and Illinois franchise laws apply to our Dessert Dreams scenario because the Chicago investor's business will be operated there. Moreover, New York's broad jurisdictional provisions mean that its franchise law will apply as well. Other states with disclosure or registration requirements are Hawaii, Indiana, Maryland, Michigan, Minnesota, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

Is it possible to structure a program to avoid the application of these laws? It is, but this means either eliminating one element of the definition or finding exemptions under federal and state law. Although these are far from uniform there are exemptions for high net worth franchisors with experience, transactions requiring large franchisee investments, experienced or sophisticated franchisees and transactions involving a new line of business.

But what happens if a business has expanded, has all of the elements of a franchise and has not complied with regulatory requirements? First, federal and state authorities can bring enforcement actions against both businesses and their individual control persons. Their armory of weapons includes fines, penalties, required relief for franchisees, rescission, and civil and criminal remedies. Additionally, private litigants may seek damages and in some cases rescission under state law, and may also target individuals controlling the business.

The issue often arises at inopportune moments. Complaints by disgruntled licensees or competitors can trigger regulatory enforcement actions or private actions. A liquidity event such as a financing, the sale of the licensor or bringing in investors generally involves a due diligence process that can uncover the issue. Questions about compliance may impair the transaction or even derail it. Even if the transaction does proceed, the potential liability may affect the purchase price or terms of investment.

When a business finds itself in a situation in which there are a number of third party-owned and operated locations and discovers this issue, there are ways to address the problem. Indeed, many companies find themselves in these straits despite having sought legal advice when initially structuring the business expansion. Remedial action is important to address existing potential liability. It can take many forms including restructuring the program, analyzing defenses such as statute of limitations defenses, self-reporting and rescission offers.

While remedial action can take a long time, one thing is certain: ignoring the problem will only increase liability.

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