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Are Your Licenses Really Franchises? How to Avoid Inadvertent Franchise Regulation

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CLIENT ALERT | 10.28.2013

To expand the scope of their business – either geographically or into additional product categories – many companies *license* their trademarks. Company "A" sells milk, for instance, and shipping milk far from its source of production may not make economic sense. A restaurateur wishes to open restaurants in other states. Another company has expertise in selling men's clothes, but would like to expand to men's shoes.

These companies could purchase businesses or start-up new divisions. Or they could license their marks to other manufacturers or service providers, thereby leveraging the goodwill of their brands with the expertise of experienced companies. The licensors must take care, however, that they do not inadvertently create a franchise – doing so could thrust the company into an expensive and strictly regulated legal environment.

Franchises can be created unintentionally, and are regulated both federally, as well as by 14 states, including several of the largest and most commercially active states. Failure to comply with these laws, even inadvertently, could mean significant fines, damages, injunctions and even criminal penalties.

Elements of a Franchise

In general, a franchise is created when three elements are combined in a continuing business relationship. These three elements will be familiar to **any** trademark licensor:

- 1) A license of the right to use a trademark;
- 2) Payment by the licensee to the licensor of royalties or fees; and
- 3) Significant control by the licensor over, or the provision by the licensor of significant assistance in, the operation of the business of the licensee.

The first element, of course, is a given in a trademark license. Licenses between parties often require payment of royalties or other types of fees, meeting the second requirement. So it is the third element that often either thrusts a licensor/licensee relationship into one of a franchisor/franchisee or ensures that it remains a license and not a franchise.

Control Over Goods

Control over the **quality** of goods produced under a license, and control over the "look" of a trademark are "de rigueur" requirements of a trademark license. Without this control, the licensee could use the mark in a manner that degrades or weakens the trademark, diminishing the customer's association of the mark with only one source. Lack of control could cause the mark to become legally abandoned and the owner no longer able to claim ownership of this asset. The result: anyone can use it.

In general, quality control over goods (when goods are the licensed products) is not deemed to be the type of control that tips the relationship into a franchise because the touchstone of franchise control is in the level of control over *business operation*. Control designed solely to protect the trademark owner's goodwill in the mark will not be deemed to be problematic business operation control. But control over where products are purchased, for example, or requirements that goods must be purchased from the licensor, or its designees, might be considered to be control over the licensee's business operations.

Control Over Services

Parties must be particularly careful when articulating the quality control over services. Too much control can be a problem.

Acceptable Types of Control

The following types of control are usually acceptable for a license: inspection of goods or services, the requirement to review reports of customer complaints and ameliorative efforts, approval of, or involvement in the design of signage, goods, packaging or promotional material for the purpose of ensuring that the mark is used correctly on each.

Possible Problematic Control

However, any or all of the following could meet the third element of a franchise – control over business operations: specific sourcing requirements, detailed operating manuals, site selection requirements, specific hours of operation, control over production techniques (beyond results-oriented requirements), control over accounting operations, human resources or other policies, requirement to participate in specific training programs or business methods, sales, etc.

In conclusion, a trademark licensor should take care not to cross the line from quality control to control over business operations methods. Otherwise, it could inadvertently create a franchise relationship, necessitating complex regulatory compliance and potentially resulting in costly fines and penalties for noncompliance.