Trademark licence or franchise: avoiding the evil twin

Companies may think they are entering into trademark licensing deals in the US, but, if they are not careful, they may unwittingly find they end up with a franchising agreement. And that may be the last thing they want

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A trademark licence is an arrangement by which the licensor consents to the use of its trademark or service mark by the licensee in accordance with agreed upon terms and conditions. It is basically permission, usually in return for compensation, to use the trademark in a specified manner.

A trademark licence may be financially rewarding to the licensor. Usually, a licensor's up-front investment is minimal, but the royalty stream may be substantial and continuous. A trademark licensing programme is often used to exploit new marks or extend the brand to new consumers. Licensees also reap benefits from a trademark licensing programme because an association with a well-recognised mark can help reduce the commercial risk of entering a new business. Licences allow an individual or small business to associate themselves with a well-known brand.

Quality control is required to maintain a trademark and, therefore, it is a fundamental aspect of a valid trademark licence. While the level of control required to maintain a trademark varies from situation to situation, some of the many factors analysed to determine whether quality control requirements have been satisfied include actual licensor supervision, reasonable inspections, product specifications, operating manuals, licensee training and express contractual provisions. As part of a successful licensing programme, the licensor should prepare and distribute trademark guidelines that include details on the use of the trademarks, from suggested artwork and the correct usage of all applicable trademarks, down to the fonts and colour schemes that must be used with the licensed trademarks.

The evil twin

In developing strategies for the implementation of a trademark licensing programme, the licensor may unwittingly conjure up a trademark licence's evil twin – the franchise, a regulated relationship for which pre-agreement disclosure is required under federal and certain state laws and also which may be limited in certain aspects over the term of the relationship and beyond by various state laws. While the trademark owner sometimes makes the strategic decision to franchise, more often the creation of a franchise relationship is an unintended result of a combination of elements in the structure of the business plan, which cause it to fall within the legal definition of a franchise.

For example, if a licensor intends to grant a simple trademark licence, the licensor must be careful not to combine certain elements in the licence agreement that may result in the agreement being construed as a franchise agreement. Significant federal and state franchise regulations govern business relationships that fall within the legal definition of a franchise – everything from the initial offer and sale of franchises to the use of prescribed disclosure documents and prescribed procedures, to regulating the relationship of the franchiser and its franchisees up to and through the termination of the franchise relationship. Also, because of the disclosure requirements, a franchiser must disclose the types of training, brand/marketing support, operating systems/support and technical support it will provide and include these obligations in the agreement.

So when is a trademark licence a franchise agreement? What is the combination of elements that triggers franchise regulations? Although there are variations under specific state laws and numerous exceptions and exemptions that may be available, in general, a business relationship is a franchise under federal and state law when the following three elements exist together:

- The right to use a trademark to offer, sell or distribute goods or services (the trademark element).
- Payment of a required fee (the fee element).
- Significant assistance or control with respect to the franchisee's business, which may take the form of a marketing plan (the assistance element).

In order to avoid coming within the legal definition of a franchise and thereby become subject to regulation under federal and state franchise laws, a licensor may not include more than two of the three basic elements listed above in its licensing agreement/programme.

Of course, since the point of the licensing programme is to license the trademark, the trademark element is essential. This leaves the fee element and the assistance element. Since the fee element is also likely to be essential to the business strategy, this element will also be present most of the time (although, as discussed later, there is a reasonably easy way to avoid the fee element under federal franchise law). Thus, the question of whether the licence is a franchise is likely to turn on the presence or absence of the significant assistance or control element.

If all three franchise elements are present, there may be a statutory or regulatory exception or exemption available that will allow the trademark licensing programme to be implemented without compliance with franchise disclosure and registration requirements. While these exceptions and exemptions are discussed later, it should be noted that under many circumstances, a particular exception or exemption is not available in every jurisdiction in which the programme is offered.

Federal franchise law is based on a rule promulgated by the Federal Trade Commission (the FTC Rule) in 1979 that specifies the minimum disclosure that must be made to a prospective franchisee in the United States. Moreover, 15 states (the franchise states) have enacted their own even more expansive statutory frameworks for the offer and sale of franchises within their borders, including a more detailed disclosure format, known as the Uniform Franchise Offering Circular (the UFOC), which supersede the FTC Rule. The franchise states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. If a business relationship falls within the definition of a franchise, the franchiser is subject to the FTC Rule and/or the more expansive regulations of one or more of the franchise states.

As soon as a business relationship falls within the definition of a franchise, federal and state regulations apply to that relationship. For example, the initial offer and sale of the franchise opportunity requires the use of a legally prescribed disclosure document, the UFOC. Also, the conduct between a franchiser and franchisees both during and upon termination of their business relationship may be governed by state statutes favouring franchisees with respect to termination, non-competition, dispute resolution and other substantive areas of the relationship. For example, some state statutes provide that a franchisee may be terminated only for good cause (even at the end of the term of the franchise agreement) and, except for the most serious breaches, must be afforded anywhere from 30 to 90 days notice of termination (180 days notice of non-renewal in some states) and at least 30 days opportunity to cure a breach. Also, some statutes require the franchiser to repurchase inventory, supplies, equipment and furnishings purchased by the franchisee from the franchiser or its designated suppliers. Finally, the obligations of the franchiser to state the degree to which the licensor will provide training, brand support, operating systems/support and technical support must be disclosed in the UFOC and will be part of a binding written contract.

In addition to the foregoing, other reasons to avoid creating a franchise relationship may include:

- A desire to avoid the required financial disclosure and the costs attendant with annual audits.
- A desire to avoid possible additional liability risks arising from statutory and common law protections in favour of franchisees in the event of termination and other aspects of the franchise relationship.
- The ability to grow and operate the distribution network without the need to provide significant assistance.
- The desire to avoid the added legal burden of compliance with initial and ongoing preparation of disclosure documents,

Does a franchise exist?

The presence of any one of the following types of control or assistance may suggest the existence of significant control or assistance sufficient to satisfy the assistance element of the definition of a franchise:

Types of control
- site approval
- site design/appearance requirements
- dictating hours of operation
- production techniques
- accounting practices
- personnel policies/practices
- required participation in, or financial
- contribution to promotional campaigns
- restrictions on customers
- restrictions on sales area or location

Types of assistance
- sales or business training
- establishing accounting systems
- furnishing management, marketing or
- personnel advice
- site selection assistance
- furnishing detailed operations manual

annual state franchise registrations and strict procedures on the mechanics of offering and selling franchises.
- Possible difficulty with the ability to modify the licensing programme due to the existence of relatively long-term contracts with existing licensees.

A closer look at the elements of a franchise
If all three franchise elements exist, the legal definition of a franchise is satisfied and what the licensor thought was a trademark licensing programme actually becomes subject to federal and state disclosure and registration requirements governing the offer and sale of franchises, as well as the state statutes governing the termination and other elements of the business relationship.

The trademark element
The trademark element is satisfied when the franchisee is granted the right to distribute goods or services under the franchiser's trademark or service mark. Since this is the essence of a trademark licence, eliminating this element will not be an option.

The fee element
If a licensee is required to pay a fee for the right to use the trademark, the fee element is present. Fees may be paid directly at the outset of the agreement or on an ongoing basis. Fees may exist in indirect or hidden forms, for example, as payments for advertising and marketing materials, required training, required purchases of products (other than inventory for resale) or services from the franchiser that are ancillary to the business, payment for equipment or unreasonable amounts of inventory from the franchiser and royalty payments. Under the FTC Rule, the fee element is present if there is a payment of at least US$500 within the first six months of the business. Thus, by delaying the amount and/or the timing of payment obligations, it may be possible to avoid the fee element under the FTC Rule (the six-month deferral is not available in the franchise states).

The assistance element
Under the FTC Rule, the key to the assistance element is that the control exercised or assistance provided by the franchiser with respect to the franchised business must be "significant". According to the FTC Guides, the term significant "relates to the degree to which the franchisee is dependent upon the franchiser's superior business expertise". The FTC Guides state that the dependence on the business expertise of the franchiser may be conveyed by the franchiser's controls over the franchisee's methods of operation or by the franchiser furnishing assistance to the franchisee in areas related to methods of operations. The presence of certain types of control or assistance could suggest the existence of significant control or assistance sufficient to satisfy the assistance element of the definition of a franchise (see box, opposite)

Most franchise states define the assistance element in terms of a "marketing plan prescribed in substantial part by the franchiser". In these states, the assistance element is applied much more broadly to include even the mere suggestion that a franchisee follow a marketing plan, regardless of whether the franchisee actually follows the marketing plan. In franchise states, a marketing plan is usually found to exist where advice or training is provided regarding sales of the franchiser's products or services, or regarding business operations.

Exceptions/exemptions to franchise regulation
A number of exceptions and exemptions are available to would-be franchisers. Two of the most important for trademark licensors are the inventory exception and the fractional franchise exemption.

Exception for bona fide wholesale price of goods or other purchases
Under the FTC Rule, there is an inventory exception from the fee element for amounts paid at a bona fide wholesale price for reasonable amounts of merchandise to be used for resale. There are similar inventory exceptions to the fee element under the laws of every franchise state for the purchase of goods in reasonable amounts at bona fide wholesale prices. Although the franchise state inventory exceptions may be broader than the FTC Rule exception, which covers merchandise only, in neither case does the exception apply to the purchase or lease of services or other intangibles, with the exception of Hawaii and Maryland, which do recognise the exception for services. If an exception applies, the franchise fee element may not be satisfied and perhaps, the franchise laws may be successfully avoided.

Fractional franchise exemption
Under the FTC Rule, a fractional franchise is defined as a relationship in which the franchisee or any of its directors or executive officers has been in the "type of business represented by the franchise relationship" for more than two years and the parties reasonably anticipate that sales from the

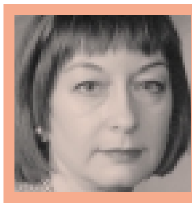
franchise will not exceed 20% of the franchisee's gross sales.

A franchisee is considered to be in the business represented by the franchise if the prospect is either: currently selling the products or performing the services covered by the franchise; or in a related business that would ordinarily familiarise the prospect with the franchised activity. Franchise state law fractional franchise exemptions are generally consistent with the FTC Rule, with the two key components being the two years prior experience in a business similar to that being franchised and the expectation that the sales generated by the franchise will not exceed 20% of the franchisee's total sales.

Reliance on the fractional franchise exemption is often problematic. The licensor may want to prohibit its licensees from selling other competing or non-competing products and services so that its dealer network is dedicated solely to the sale of licensed products and services. If the agreement is structured so that licensees are limited to sales of licensed products, only the 20% sales limit will be exceeded and the fractional franchise exemption will not be available. However, if a licensed dealer is permitted to sell non-licensed products and services, for purposes of the 20% limitation, the goal of increasing sales of the branded products and services is contrary to the 20% limitation. Moreover, monitoring sales of every licensee to ensure compliance with the maximum threshold is an extremely burdensome task. Finally, as with other exemptions or avoidance strategies, the fractional franchise exemption is not available in some franchise states.

Conclusion

Whether or not a trademark licensor intends to franchise, if all three franchise elements are present in a business relationship, the requirements of federal and state franchise regulations apply. If this result is not desirable, then one of the three franchise elements must be removed from the structure of the licence or business relationship, or one of the exemptions or exceptions must be available. Since the essence of the trademark licence is the right to use the trademark, however, this leaves the fee element or, more often, the assistance element to be adjusted. There are also a variety of federal and state law exceptions and exemptions to be considered, but no single strategy works for all federal and state laws. Ultimately, the trademark licensor who desires to avoid the regulatory requirements of a franchise may have to alter the structure of its licensing programme.



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Mr Hampton was the Assistant Commissioner for Trademarks at the USPTO from 1994 to 1998. As CEO of the trademark operations in the United States, he oversaw the reengineering of the Trademark Office. He also promulgated almost 200 Commissioner's Decisions and oversaw the first new edition of the Manual of Trademark Examining Procedure in almost 10 years.

Mr Hampton has been involved in all aspects of patent and trademark litigation in US district courts, mini-trials, ITC Section 337 hearings, and Trademark Trial and Appeal Board opposition and cancellation proceedings.