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Inadvertent franchise relationship: What you should watch for

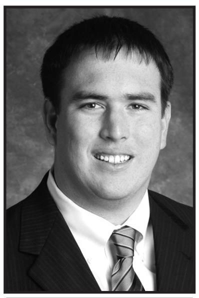
Franchising, a versatile business model, is not limited to fast-food restaurants. Colorado is home not only to familiar franchise concepts such as Smashburger, but also to concepts not routinely thought of as franchises including Crestcom International and Living Well magazine.

Colorado real estate attorneys working with clients with lease agreements, hospitality venues, licensing, tax, zoning, financing, regulatory and other issues should be on the lookout for the inadvertent franchise relationship because such a relationship can create unanticipated legal consequences. These include civil and criminal penalties, private actions for rescission and damages, and individual liability for control persons. Taking the time to understand the nature of your client's business and being able to assess whether or not an inadvertent franchise relationship exists allows you to respond carefully to evolving legal needs.

A Rose by Any Other Name

Parties cannot escape laws surrounding franchises by simply deciding to name their transaction or agreement something other than a franchise. If an agreement has all the elements of a franchise, it's a franchise – regardless of whether it's called a "license agreement," "dealership agreement," "joint venture," "consulting and supply agreement" or any other creative name.

The dangers of being an inadvertent franchisor are real – as many have learned the hard way when facing: 1) an unexpected regulatory enforcement investigation; 2) a lawsuit by a terminated putative franchisee claiming protection of franchise law; or 3) a major glitch in the sale of a company when the buyer's due diligence uncovers a possible unregistered franchise. You must be able to spot the three telltale signs of a franchise relationship.



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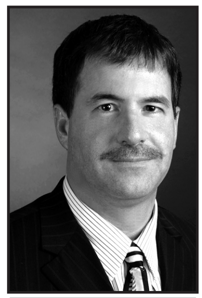
The Three Signs

There are three main elements to the definition of a franchise under federal law and most state franchise laws.

■ **Substantial association with trademark.** For a franchise to exist, the business must be substantially associated with the franchisor's trademark or other commercial symbol. The law does not require a license or grant of trademark rights. The trademark requirement is most commonly met when the putative franchisee uses the franchisor's name. Since franchise laws were enacted to remedy perceived abuses in the treatment of franchisees, courts interpret those laws broadly. One California court found that there was a substantial association with a company's trademark even though its use was prohibited and the mark was never communicated to the customers of the business.

■ **Payment of a fee.** A payment by a putative franchisee does not have to be labeled a "franchise fee" to satisfy this element. Rather, ongoing royalty payments or other payments characterized as "consulting fees," "site assistance fees," fees for rent, equipment, supplies or training are sufficient as long as they are connected to the right to operate the business. Many state laws have *de minimis* exemptions for fees that total insignificant amounts. Each of the franchise laws exempt payments for goods for resale if the purchaser pays a bona fide wholesale price and if the purchaser is not required to purchase more than an amount that a reasonable business person would for his inventory.



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■ **Significant control or assistance/marketing plan/ "community of interest."** Under federal law, the significant control or assistance element is satisfied if the franchisor either 1) exerts, or has the power to exert, a significant degree of control over the franchisee's method of operation; or 2) provides significant assistance to the franchisee in connection with the operation of the business.

The Federal Trade Commission identifies "significant types of control" as those involving the following: (a) site approval for unestablished businesses, (b) site design or appearance requirements, (c) hours of operation, (d) production techniques, (e) accounting practices, (f) personnel policies and practices, (g) promotional campaigns requiring putative franchisee participation or financial contribution, (h) restrictions on customers, and (i) location or sales area restrictions.

The "significant types of promises of assistance" to the franchisee's method of operation include those that follow: (a) providing formal sales, repairs or business training programs, (b) establishing accounting systems, (c) furnishing management, marketing or personnel advice, (d) selecting site locations, and (e) providing a detailed operation manual.

In addition, many states follow California's lead and adopt as a third element a requirement that a franchisor prescribes a marketing plan in substantial part. Courts will look to factors such as 1) whether the licensor provides promotional materials; 2) whether the licensor provides operations manuals requiring standards and specifications; 3) whether the licensor requires training to be completed to satisfaction; and 4) how free the putative franchisee is to make decisions without first obtaining the licensor's approval. The type of control that a licensor retains must be substantial and not limited to only a small part of the business.

Some states follow a different standard and require parties to have a community of interest in the operation of the business. This concept is difficult to define precisely. At a minimum, there must be a continuing financial interest between the parties and they must be interdependent. Salient factors include these: 1) the length of time the parties have been involved; 2) the extent and nature of their obligations; 3) the relative amount of time and revenue attributable to the licensor's products and services; 4) the percentage of revenues received from the licensor's products or services; 5) any territorial grant; 6) the use of a licensor's trademarks by the putative franchisee; 7) the investment in inventory, facilities and goodwill; 8) the proportion of the putative franchisee's personnel that work on this part of the business; 9) advertising expenditures for the licensor's products or services; and 10) the extent of any supplemental services.

Most states apply a fact-driven analysis that requires careful consideration of the above factors to determine if the third element of a franchise relationship exists.

■ **Conclusion.** If you believe you recognize the three elements of a franchise relationship, you may be in an inadvertent franchise relationship.▲