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Franchising 101: Key Takeaways for IP Lawyers

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Kitt has assisted dozens of companies in structuring, forming, launching, and growing successful franchise programs in numerous industries for over 20 years. Kitt routinely counsels franchise companies and private equity on the purchase and sale of franchise systems, and represents individual owners in the purchase and sale of existing businesses. In addition, she counsels clients on the purchase of franchise rights, assisting in the review of franchise disclosure documents, franchise agreements, development agreements, area representative agreements, and master rights agreements.

Prior to joining the Kilpatrick Townsend & Stockton LLP, Kitt was a partner in a boutique franchise and business law firm based in Atlanta, Georgia where she was a founding partner. Her practice included franchising, mergers and acquisitions, commercial contracts, leasing and related transactional matters. Kitt started her career in law as an associate at Kilpatrick Townsend in its Atlanta, Georgia office where she concentrated her practice on licensing and franchising, securities, and mergers and acquisitions. She has also served as in-house counsel, where she was responsible for all legal matters for several internationally known franchise brands. Kitt is recognized by Franchise Times as a "Legal Eagle".

On March 26, Kilpatrick Townsend's Brand Licensing and Franchise Partner Marc Lieberstein paired up with Jason Adler, General Counsel at Cellairis, a global franchisor in the wireless accessory and repair retail space to present a webinar titled, "Franchise 101 for IP Lawyers." The following article is an overview of U.S. franchising, based on that webinar which addressed the importance of compliance with federal and state laws governing franchising, the valuable role of trademarks and other IP assets for franchisors, and how to spot a franchise in other related IP transactions, like trademark license agreements. The webinar also covered current topics in franchising, such as joint employment liability and avoiding the associated franchise risks, as well as data security, the new Item 19, changes in arbitration, corporate social responsibility in franchising, and the latest developments around nonsolicitation/"no-poaching" provisions regarding franchisee employees. Below are six franchising takeaways from the webinar.

1. Franchise Disclosure Document

Franchising is a big growth business in the U.S. with over 800,000 franchise establishments in operation, generating almost a trillion dollars in revenue. Franchising is also a business model that is subject to a complex set of regulations, which include federal and state laws that govern franchise sales and franchise relationships. At a minimum, before offering to sell a franchise, a franchisor must have a Franchise Disclosure Document (FDD) that complies with the federal laws (16 C.F.R. § 436), and, in 14 states, a franchisor must register its franchise offering before a sale may be made. Failure to do so can result in damages, sanctions, and penalties, and could also result in a franchisor being required to offer rescission to franchisees. Among the 23 Items in an FDD, a franchisor must include the business experience of all officers, executives, and others with management responsibility for franchise sales or operations; certain lawsuits and bankruptcies; estimates of the franchisee's initial investment; recurring fees such as royalties and ad fund contributions; a sample of the franchise agreement and any other proposed agreements relating to the franchise offering (*e.g.,* personal guarantee, lease riders); and audited balance sheets for its two preceding fiscal years and statements of operations, equity, and cash flows for its three preceding fiscal years. The FDD must be delivered to a prospective franchisee at least 14 days before a franchisee executes the franchise agreement or pays any fees to the franchisor under federal law (note this "cooling off period" may be different under the laws of certain states). Recently, new rules were implemented providing further clarifications and requirements regarding the presentation of financial performance data in Item 19 of the FDD, which, in general, require additional and more balanced reporting and impose requirements regarding the use of subsets and combining data from company outlets and franchised units.

2. What Is a Franchise?

In general, a franchise encompasses (1) a license to use or otherwise be associated with another's trademark; (2) a method of doing business that involves the brand owner providing significant assistance and/or exercising significant control over the other party's operations; and (3) a fee paid to the brand owner. Be advised that this definition varies from state to state, and the state definitions may vary from the federal law definition, as perfectly exemplified by New York's definition of a franchise which omits element (2).

3. Franchise Advantages and Disadvantages

Advantages of franchising include customized and accelerated growth for the franchisor; lower long-term risk/capital investment for the franchisor (franchisee takes on the initial capital investment); typically, a franchisee that is motivated to succeed because of its investment; and franchisee access to established supply chain, brand equity, and operating/support systems provided by the franchisor. Disadvantages of franchising include loss of control by the franchisor to the franchisee "owner"; federal and state law franchise regulatory compliance for the franchisor; high initial investment costs and less revenue for the start-up franchisor; potentially onerous franchisor and franchisee obligations; and, for a franchisor, potentially exposing itself to liability for a franchisee's business activities.

4. Maintaining and Protecting IP Interests

IP is at the heart of any franchise system. Brand owners in franchising must make sure they maintain their trademark value, employ filing strategies to keep trademark registrations in line with use; have strict controls over trademark and IP use by franchisees to ensure quality control; monitor for unauthorized use; and develop enforcement strategies to maintain the distinctiveness of the trademark. The same concepts apply to franchise systems where technology may be the most crucial asset, *e.g.,* patents and trade secrets.

5. Structural Elements of a Franchise

The structure and elements for most franchise agreements include (1) consideration to be paid to the franchisor in exchange for the franchise, including the initial franchise fee, and other fees such as royalties, renewal fees, transfer fees, and technology fees; (2) a description of the advertising fund, required advertising fund contributions, advertising coops and required local advertising expenditures; (3) territorial protections; (4) preopening obligations such as training, site selection, and construction requirements; (5) sourcing requirements and requirements regarding equipment, supply, and inventory purchases; (6) redesign/update obligations; and (7) termination and post-termination provisions. Royalties range from 4 to 10 percent depending on the industry segment; ad fund contributions range from 1 to 4 percent of revenue and initial franchise fees range from $25K to $75K depending on the maturity of the franchisor and the industry segment.

6. Current Hot Topics and Issues in Franchising

As for the hot topics: (1) It's no secret that parties in franchising must make sure that they are compliant with the most recent data privacy laws, including new laws that the individual states are passing, *e.g.*, California. (2) The National Labor Relations Board (NLRB) previously required direct control over a franchisee's employees for joint employer liability to apply, but a recent 2015 NLRB decision changed that standard to "indirect control". However, in September 2018, the NLRB released a proposal to go back to the former standard requiring direct control, and most believe that direct control will be required under the NLRB standard in the future. In *Dynamex Operations W. v. Superior Court*, 4 Cal. 5th 903 (2018), California made it more difficult for employers to classify workers as independent contractors by adopting the ABC test. Under the ABC Test, a worker is presumed to be an employee under wage and hour laws unless the hiring entity can affirmatively show (A) the worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact; (B) the worker performs tasks that are outside of the usual course of the hiring entity's business; and (C) the worker is customarily engaged in an independently established trade, occupation or business of the same nature as the work performed for the hiring entity. In May of 2019, the Ninth Circuit ruled in *Vazquez v. Jan-Pro Franchising Int'l, Inc.*, 923 F.3d 575 (9th Cir. 2019) that the Dynamex ruling applied retroactively to franchisor-franchisee relationships. (3) Franchises are implementing corporate social responsibility (CSR) programs not only to comply with tougher laws, but also to satisfy consumer demand for brands that give back to the community or that are taking steps to be environmentally friendly. Survey evidence shows that over 50 percent of consumers will pay extra for a brand that is participating in CSR. And almost 70 percent of prospective employees (talent) want to work with companies that are actively engaged in CSR. (4) After the recent Supreme Court case *Henry Schein, Inc. v. Archer & White Sales, Inc.*, 139 S. Ct. 524 (2019) franchise parties who want arbitration to govern all disputes, including whether a claim is subject to arbitration, should expressly state this in their franchise agreement. (5) No-poaching provisions in franchise agreements, which prohibit the solicitation of employees not only between franchisor and franchisee, but also between franchisees, are under attack and can be deemed invalid/unenforceable.