



Insights: Perspectives

6 Key Takeaways | Franchise 101 for IP Lawyers

April 5, 2019

6 KEY TAKEAWAYS

Franchise 101 for IP Lawyers

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." Marc and Jason provided an overview of U.S. franchising, 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. They also reviewed several 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 development around non-solicitation/"no-poaching" provisions regarding franchisee employees. Below find six webinar takeaways:

Key takeaways from the presentation include:

1

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. It is also subject to a complex set of regulations, which include federal regulations and state laws and regulations 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 at least 14 states a franchisor must first file an application to register its franchise with the state beforehand. Failure to do so can result in damages, sanction, and penalties and could also invalidate any agreements the franchisor signed if it was not in compliance. Among the 23 Items in an FDD, the franchisor must disclose balance sheets and financial statements of the franchisor company for the two preceding years; a description of all franchise officers, sales personnel, and pending lawsuits; estimates of franchisees initial investment, royalties, marketing fees, etc.; and a draft of the franchise agreement and any other preliminary instrument (e.g., personal guarantee). Most important for any franchisor is that the FDD must be delivered to any prospective franchisee within 10-14 days (depending on the applicable state or federal law) before a franchisee executes the franchise agreement or pays any fees to the franchisor. Recently, new rules were implemented regarding financial performance representation in Item 19 of the FDD, which in general require additional and more balanced reporting on sales, profits, etc.

What is a franchise? In general a franchise encompasses (1) a license to use or otherwise be associated with another's trademark, (2) along with a method of doing business wherein the brand/business owner is providing significant assistance and/or exercising significant control over the other party's operation of the business, and (3) a fee paid to the brand/business 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 in that it omits Element (2) from its definition of a franchise.

2

3

Advantages of franchising include customized and accelerated growth for the franchisor; lower long-term risk/capital investment for the franchisor (franchisee takes it on initial large investment); a typically motivated franchisee to succeed because of its investment; and access to established supply chain, brand equity, and established operating and support systems by the franchisee. Disadvantages of franchising include loss of control by the franchisor to the franchisee "owner"; federal and state law franchise regulatory compliance for the franchisor; initial high investment and less revenue for the franchisor;

compliance for the franchisor, including investment and fees; franchisee must comply with all applicable laws and industry regulations.

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 registrations in line with use; have strict controls over 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.

4

5

The structure and elements for most franchise agreements include (1) provisions on franchise fees, renewal fees, royalty rates, marketing, and technology fees; (2) formation of a franchise association, territory, Area Development Agreement option, training requirements and fees; and (3) monitoring and compliance obligations, termination, and redesign/update obligations. Royalties range from 5-10 percent depending on the basis; Marketing/Advertising/Technology fees range from 1-4 percent and Franchise/Renewal fees range from \$0 to \$75K, but this varies among the franchise sectors.

As for the hot topics:

- 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.
- While the present law technically says that a franchisor could be liable as a joint employer with its franchisee if the franchisor could exercise direct or indirect control over the franchisee employees, at least one recent decision removed the "indirect control" element from the liability standard, and most franchise practitioners believe that direct control will likely be the necessary component for such liability. But to avoid joint employer liability, it's a good practice for a franchisor to avoid providing franchisees with employee handbooks; getting involved with franchisee employee hiring, firing, scheduling, training, and uniforms; and co-mingling operations with a franchisee, such as pricing, inventory, and insurance.
- 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.
- After the recent Supreme Court case *Henry Schein, Inc. v. Archer & White Sales, Inc.* 586 U.S. ____ (January 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.
- 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.

6

For more information, please contact Marc Lieberstein: mlieberstein@kilpatricktownsend.com

www.kilpatricktownsend.com