THE NATIONAL
LAW JOURNAL
DAILY UPDATES ON WWW.NLJ.COM THE WEEKLY NEWSPAPER FOR THE LEGAL PROFESSION MONDAY, MAY 12, 2008 ALM

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INTELLECTUAL PROPERTY

How to avoid the franchise surprise

In some states, license relationships may be construed as franchises.

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SPECIAL TO THE NATIONAL LAW JOURNAL

BRAND OWNERS MUST beware the franchise surprise when they license their trademarks. Today, franchises come in many shapes and sizes, from Jenny Craig to California Closets, from Carvel Ice Cream to Lawn Doctor, from 7-Eleven to Pearle Vision Center. Since the 1950s, franchising has exploded. There are now believed to be more than 750,000 franchised businesses in the United States, accounting for 40% of all retail sales; one out of every 12 businesses in the United States is a franchise. With this increase in franchising business have come federal and state regulations that brand owners licensing their trademarks need to know for their respective jurisdictions. Why? Because in many states the statutory definition of "franchise" has been, and could be, construed broadly to include relationships between brand owners and their trademark licensees even though neither party intended to create a franchise. Consequently, brand owners can only avoid the franchise surprise if they know the rules of the game.

Every time brand owners license a trademark they have fulfilled one, if not more, of the statutory elements that create a franchise in most states. Brand owners that cannot avoid the other statutory franchise elements may find themselves subject to federal or state franchise regulations. The accidental creation of a franchise could also have significant financial consequences for a brand owner's business in the form of damages, rescission of the agreement, fees or fines for noncompliance.

At the federal level, franchises are governed by the Federal Trade Commission (FTC) franchise rules, 16 CFR 436.1 et seq. Under these rules, a franchise is formed by an oral or written agreement containing the following three elements: use of a trademark—the franchisor offers the right to sell or distribute goods or services associated with the franchisor's trademark; significant degree of control—the franchisor exercises significant control over, or provides assistance in, the franchisee's business; and payment of a fee—the franchisee makes, or commits to make, a required payment to the franchisor, excluding payments for goods at a bona fide wholesale price for resale.

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Individual state franchise laws differ in their scope and application, with some states only applying statutory "franchise" definitions in specific commercial contexts, such as the regulation of motor vehicles. However, in states where franchises are more broadly regulated, the statutory definitions largely resemble the FTC rule and require the presence of all three elements. Typically, franchise laws apply to those brand owners that are located in a particular state and license their trademarks within or outside the state, or are located outside of the state and form a trademark licensee relationship within the state.

Notably, if a brand owner's/licensor's trademark license happens to fall within the scope of a state's franchise statute, the licensor could find itself unintentionally operating a franchise in violation of the state's franchise regulations. To illustrate the rules of the "franchise" game for unsuspecting brand owners, this article will review the franchise law in California, New Jersey and New York. Using these states as examples, brand owners should be able to navigate most state franchise rules and, if desired, avoid the "franchise" tag when licensing their trademarks.

California and New Jersey

California has two general franchise laws: the California Franchise Relations Act (Calif. Bus. & Prof. Code §§ 20000-20043) and the California Franchise Investment Law (Calif. Corp. Code §§ 31000-31506).

The "franchise" elements under both California laws require the use of a trademark, the existence of a "marketing plan" prescribed in substantial part by the brand owner and the licensee's payment of a "franchise fee." Calif. Bus. & Prof. Code § 20001; Calif. Corp. Code § 31005. Exempted from the definition of "franchise fee" is the licensee's purchase of goods at a bona fide wholesale price. Calif. Bus. & Prof. Code § 20007; Calif. Corp. Code § 31011. As in many other states, if the elements of the statute are met, then a franchise may be deemed created, even if a contract expressly states otherwise. *Gabana Gulf Distribution Ltd. v. Gap Int'l Sales Inc.*, No. C 06-02584, 2006 U.S. Dist. Lexis 59799, at *19-*20 (N.D. Calif. Aug. 14, 2006).

California courts broadly construe the 'franchise' definition.

California courts broadly construe the "franchise" definition, but nevertheless have been careful when examining whether a trademark licensee's payments constitute franchise fees. For instance, a trademark licensee's expenses for telephone line fees and computer terminal costs were deemed not a franchise fee and "nothing more than ordinary business expenses and not an investment required by [the brand owner] for the right to operate a dealership." *Thueson v. U-Haul Int'l*, 144 Cal. App. 4th 664, 673, 676 (Calif. 1st Ct. App. 2006). But a surprise franchise relationship was found between a manufacturer of record-keeping systems and office products and its commissioned sales agents, even though the sales agents did not offer, sell or distribute goods or services under a marketing plan, because the sales agents, among other things, solicited orders and actively interacted with customers. *Gentis v. Safeguard Business Systems*, 60 Cal. App. 4th 1294, 1305 (Calif. 2d Ct. App. 1998).

Brand owners should be aware of New Jersey's Franchise Practices Act (NJFPA). If a licensee is located in New Jersey, courts will apply the NJFPA to cover the brand owner/licensee relationship even when the application of New Jersey law supersedes the contractually agreed-upon choice-of-law clauses selecting the law of another state. *Instructional Sys. v. Computer Curriculum Corp.*, 130 N.J. 324, 341-46, 367 (N.J. 1992). Also, when New Jersey law governs an agreement encompassing a multistate territory, the NJFPA can have extraterritorial reach over franchise activities in the other states. *Instructional Sys. v. Computer Curriculum Corp.*, 35 F.3d 813, 825 (3d Cir. 1994).

The 'community of interest' element is key in New Jersey.

New Jersey's unique statutory "franchise" definition does not require a "franchise fee," but does require a "license to use a trademark," a "community of interest," as well as gross sales of products between the franchisor and the franchisee exceeding $35,000 for the 12 months preceding the institution of suit pursuant to the NJFPA, with not more than 20% of the licensee's gross sales intended to be derived from such franchise. It also requires that the franchisee's business be in New Jersey. N.J. Stat. § 56:10-3 - 56:10-4. Clearly, the NJFPA can be avoided in several ways, the simplest of which would be to not have more than $35,000 in direct sales to a licensee, i.e., let others deal directly with the licensees.

Brand owners can easily circumvent the "license to use a trademark" element of the NJFPA because merely selling goods or distributing materials bearing the manufacturer's name or trademark does not constitute a "license to use a trademark" within the meaning of the NJFPA. *Atlantic City Coin & Slot Serv. Co. v. IGT,* 14 F. Supp. 2d 644 (D.N.J. 1998) (citation omitted). Brand owners, however, must be careful to avoid creating the impression in the mind of consumers that there is a connection between the brand owner and the licensee, such that the brand owner "vouches for" the activity of the trademark licensee.

For example, a relationship was deemed a "franchise" when, through advertising and signage, the distributor used the manufacturer's trade name "in such a manner to create a reasonable belief [by consumers] that there is a connection between them." *Cooper Distributing v. Amana Refrigeration*, No. 91-5237, 1992 U.S. Dist. Lexis 17918, at *8, *10 (D.N.J. Jan. 23, 1992). Accordingly, while brand owners can and should control and monitor their licensed products and services, they should not interfere too much with the licensee's actual business operation to create the false impression that the brand owner and licensee are affiliated in other ways.

Brand owners also need to be aware of the "community of interest" franchise element of the NJFPA, which reviews factors such as a licensor's control over the licensee, the licensee's economic dependence on the licensor and the presence of a franchise-specific investment by the licensee. Id. The "community of interest" element was used to find a franchise when, although the distributor at all times operated under its own name and did not adhere to any structural or procedural scheme and never paid a license fee, the distributor had the right to use the producer's name, trademark and logo in its advertising, exhibits, trade shows, public relations materials and manuals, and the duty to use its best efforts to promote the producer's products, which had the effect of appearing to consumers that the two entities were related. *Instructional Sys.*, 130 N.J. at 351-55.

Broad definition in New York

New York's statutory "franchise" definition is considered among the broadest in the country. No New York cases were found in which a court converted a trademark license into a franchise, but under New York's franchise statute it would seem that such a conversion could occur under a variety of circumstances.

While most jurisdictions require both a "marketing plan" (or "community of interest") and use of a trademark or other commercial symbol, New York requires only one or the other to exist, plus the payment of a "franchise fee" in order for a "franchise" relationship to exist. N.Y. Gen. Bus. Law § 681.

New York's franchise law also contains a list of exceptions excluding certain types of payments from the statutory definition of "franchise fee," including payment for products at the bona fide wholesale price; payment of a fee not exceeding $500 annually when the licensee receives sales material of equal or greater value than its payment; and the purchase of sales-demonstration equipment and materials furnished at cost for use in making sales and not for resale. N.Y. Gen. Bus. Law § 681(7)(a). Payments for ordinary business expenses to unaffiliated third parties do not constitute "franchise fees." *In re The Matterhorn Group Inc. v. SMH Inc.*, nos. 97-B-41274, 97-B-41277, 97-B-41275, 97-B-41278, 97-B-41276, 2000 WL 1174215, at *9 (Bankr. S.D.N.Y. Aug. 17, 2000).

The above statutory carve-outs are intended to protect brand owners from the franchise surprise. But New York's case law is not clear regarding monetary payments that may constitute a "franchise fee." Recent New York cases focused on the existence of hidden franchise fees—payments by a trademark licensee that could be the equivalent of a franchise fee. For example, a one-time fee or a monthly payment during a four-year period, which was characterized as a "lease," was ruled a "franchise fee." *Zito v. Leasecomm Corp.*, No. 02 Civ. 8074, 2003 U.S. Dist. Lexis 17236, at *80-*81 (S.D.N.Y. Sept. 30, 2003). Fees paid to distribute the brand owners' products, coupled with marketing fees to benefit the brand owners, were held to be adequate allegations of a franchise fee. *Cal Distributor Inc. v. Cadbury Schweppes Americas Beverages Inc.*, No. 06 Civ. 0496, 2007 U.S. Dist. Lexis 854, at *19 (S.D.N.Y. Jan. 5, 2007).

On the other hand, a "franchise fee" was not found when a trademark licensee was "required to bear the cost of designing, constructing, opening and operating its Swatch stores as a condition to the right to sell Swatch products" and "part of the wholesale price it paid for inventory was to be allocated to Swatch 'coop' advertising, and if not used, retained by [the brand owner]." *In re The Matterhorn Group Inc.*, 2000 WL 1174215, at *9. Since the costs of construction and other costs incurred by the trademark licensee were not paid directly to the brand owner, the court held that these expenses did not constitute a hidden franchise fee.

Recent New York cases focus on hidden franchise fees.

The state franchise statutes and case law raise many unanswered questions for brand owners: Will royalty payments meet the statutory definition of a "franchise fee"? Can a brand owner circumvent the statutes merely by requiring a trademark licensee to make all advertising-contribution payments to a third party? Would this still qualify if any of the unused payments revert to the brand owner as part of a required royalty payment? Are "design fees" or other one-time fees considered "franchise fees" if they are more than $500 and paid directly to the brand owner? Accordingly, brand owners should proceed with caution when entering into trademark licenses that fall under franchise law. NLJ