



Guiding You Through the Legal Maze.SM

LICENSING VS. FRANCHISING

**© 2015 Keith J. Kanouse
Kanouse & Walker, P.A.
One Boca Place, Suite 324 Atrium
2255 Glades Road
Boca Raton, Florida 33431
Telephone: (561) 451-8090
Fax: (561) 451-8089
E-mail: Keith@Kanouse.com**

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LICENSING VS. FRANCHISING

License Arrangement

A license arrangement is primarily composed of 2 elements: (1) the license of a name and/or logo; and (2) the payment of initial and/or ongoing license or royalty fees. A licensor can "police" trademark (such as display of the mark or right of inspection) but cannot provide significant assistance to the licensee or significant control over the licensee that a franchisee can provide. In a true license arrangement, a licensor is limited in the amount of initial and ongoing assistance it can provide to a licensee. A licensee is also limited in the degree of control it can exert over the licensee's method of operation. These limitations will, from a practical standpoint, adversely affect the fees that the licensor can charge the licensee for the license and limit the licensor's ability to demand certain uniformity among all businesses using the licensed mark.

Franchise Arrangement

A franchise relationship contains 3 elements, the first 2 being similar elements as a license: (1) the licensee/franchisee sells goods or services which meet the licensor's/franchisor's quality standards and operates under the licensor's/franchisor's marks or which are identified by the licensor's/franchisor's mark; and (2) the licensee is required to make a payment of \$500 or more to the licensor/franchisor or a person affiliated with the licensor/franchisor at any time before or within 6 months after the business opens (excluding the wholesale price of inventory). However, in order for the license arrangement to become a franchise arrangement, the arrangement must also include the licensor exercising significant control over, or gives the licensee significant assistance in, the licensee's method of operation

The FTC Franchise Rule Interpretive Guides sets forth 9 examples of significant types of controls and 5 examples of significant promises of assistance over the franchisee's entire method of operation.

Significant Types of Control

- (i) Site approval for unestablished business;
- (ii) Site design or appearance requirements;
- (iii) Hours of operation;
- (iv) Production techniques;
- (v) Accounting practices;
- (vi) Personnel policies and practices;
- (vii) Promotional campaigns requiring the franchisee's participation or financial contribution;
- (viii) Restrictions on customers; or

- (ix) Location or sales area restriction.

Significant Types of Promises of Assistance to the Franchisee's Method of Operation

- (i) Formal sales, repair or business training programs;
- (ii) Establishing accounting systems;
- (iii) Furnishing management, marketing or personnel advice;
- (iv) Selecting site locations; or
- (v) Furnishing a detailed operating manual.

In addition to the above listed elements - the presence of any of which would suggest the existence of "significant control or assistance" the following additional elements will, to a lesser extent, be considered when determining whether "significant" control or assistance is present in a relationship:

- (i) A requirement that a franchisee service or repair a product (except warranty work);
- (ii) Inventory controls;
- (iii) Required displays of goods; or
- (iv) On-the-job assistance in sales or repairs.

The following elements are not considered in determining whether "significant" control or assistance exists:

- (i) Trademark controls designed solely to protect the trademark owner's legal ownership rights in the mark under Federal and state trademark laws (such as display of the mark or right of inspection);
- (ii) Health or safety restrictions required by Federal or state laws or regulations;
- (iii) Agreements between a retailer and a trading stamp company providing for the distribution of trading stamps in connection with retail sales of merchandise or service;
- (iv) Agreements between a bank credit interchange organization and retailers or member banks for the provision of credit cards and credit services; and
- (v) Assisting distributors in obtaining financing to be able to transact business.

What if the License Arrangement is Held to be a Franchise?

The obvious advantages of licensing over franchising include reduced legal costs, reduced accounting and auditing costs, no registration and approval of the license program with any state, and quicker entry into the marketplace. This is because licensing is not subject to the FTC Franchise Rule or and other federal law or rule requiring pre-sale disclosure. Licensing is also not subject to state franchise disclosure and registration laws or business opportunity disclosure and registration laws.

While there are certain advantages to embarking on a license program rather than a franchise program, there may also be the risk that the license program will be construed to be an illegal franchise if challenged by an unhappy licensee. The cost of defending the license program in just instance may prove to be more costly than if the franchise laws were complied with at the inception of the program. If the disgruntled licensee is successful, the license may have the right to sue for rescission (seeking the return of all monies paid to the licensor plus any losses, court costs, attorneys' fees and interest) or a suit for damages.

Conclusion

To develop and implement a true license program, these types of assistance and controls must be avoided not only in the written License Agreement but also in practice. This may be difficult for many businesses particularly retail businesses. It is important in this regard to have an attorney experienced in licensing and franchising to part of the team involved in creating the business expansion model.

Keith J. Kanouse, Esq.