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THE TWILIGHT ZONE

BETWEEN

TRADEMARK LICENSING

AND

FRANCHISING

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THE TWILIGHT ZONE BETWEEN TRADEMARK LICENSING AND FRANCHISING

As you are aware, there is a large and ever-growing multi-billion dollar trademark licensing industry. More and more companies are leveraging the value of the their intellectual property beyond the products and services associated with their goods and/or services through the license of their names, symbols, marks, devices, images, designs or phrases used to distinguish their products, services, businesses or individuals to third parties. This is particularly true of colleges, universities and professional sports. This is accomplished usually through a written license agreement between the owner of the trademark and the licensee granting the licensee the right to use the trademark in accordance with the terms of the license agreement.

Trademark licensing is distinguished from other forms of intellectual property licensing (patent, know-how, copyright) by the requirement for the licensor to control the nature and quality of the goods or services sold under the trademark. The licensor and its counsel must ensure that the terms of the license agreement are sufficient to avoid the claim that the license agreement constitutes a “naked” license for failure to exercise adequate quality control over the use and therefore the license has “abandoned” its mark. However, the terms must not be so excessive that the license agreement constitutes a “franchise” under the Federal Trade Commission’s Franchise Rule (12 C.F.R. Part 436) or state franchise laws. This article discusses what assistance the licensor provides to the licensee and what controls the licensor exerts over the licensee’s method of operation that may cause the business arrangement to be construed to be a franchise rather than a true license agreement.

This is an important issue for intellectual property attorneys to avoid the license arrangement being an inadvertent violation of federal and state franchise laws because a violation may constitute an unfair or deceptive trade practice under state law entitling an unhappy licensee to have claims for rescission of the license agreement and/or damages including attorneys’ fees, interest and court costs. There may also be personal liability for the principals of a business entity licensor making these individuals, in effect, unwittingly ‘guarantors” of the success of the licensee. Unfortunately, there is no bright-line test but the FTC has provided guidance in its Interpretive Guidelines and in informal advisory opinions as to the circumstances when a business arrangement intended to be a license becomes a franchise. This analysis is fact-specific and must done on a case-by-case basis.

A “True” Trademark License Arrangement

A trademark 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" the trademark (such as the display of the mark, right of inspection and quality control). In a true license arrangement, a licensor is limited in the degree 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.

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Some typical trademark license provisions, including quality control provisions, are as follows;

(a) The licensee's agreement to quality standards established by the licensor;

(b) The licensee's acknowledgment of Licensor's right to control quality.

(c) The licensor's right to inspect the Licensee's business premises to observe the manufacturing process.

(d) The licensor's approval of the licensee's packaging, advertising, and that manner of the licensee's use of the trademark;

(e) The licensee's acknowledgment of the validity of trademark, its ownership by the licensor, and an agreement by the licensee not to challenge the licensor's ownership or the validity of the trademark; and

(f) The definition of the products or services to be licensed, the geographical territory, the exclusive or nonexclusive nature of the grant, the royalty payments, and the applicable law.

From a practical standpoint, when compared to the typical franchise arrangement, these limitations will limit the amount of 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.

<u>Franchise Arrangement</u>

Not all license arrangements constitute a franchise but nearly all franchise arrangements include a trademark license or substantial association with the franchisor's mark. Under the FTC Franchise Rule, a franchise relationship contains 3 elements, the first 2 being similar elements of 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 a 3rd element of the licensor exercising significant control over, or gives the licensee significant assistance in, the licensee's method of operation

In the Statement of Basis and Purpose accompanying the FTC Franchise Rule, the FTC distinguished between trademark licensing and business format franchising as follows:
The primary difference between simple trademark licensing and package franchising is in the type and degree of control exercised by the franchisor and licensor. The trademark licensor is interested in the quality of the final good produced by the licensee, not in the licensee's method of operation. The kind of control he exercises is thus likely to be limited to "passive" control such as inspection of product goods and testing to insure that quality standards are met. Package franchising, on the other hand, involves active control over the franchisee's "method of operation": The location of the business, the hours of operation, the management of the business, and other business matters. 43 Fed. Reg. 59,614 at 59,710 (December 31, 1978).

Under the FTC's Interpretive Guidelines, the term "significant" relates to the degree to which the franchisee is dependent upon the franchisor's superior business expertise—an expertise made available to the franchisee by virtue of its association with the franchisor. The franchisee, in order to reduce its business risks or enhance its chances for business success, relies upon the availability of this expertise to avoid business mistakes that it otherwise might make. The franchisor conveys its expertise either by exercising controls over the franchisee's method of operation of the business or by furnishing assistance to the franchisee in areas relating to the franchisee's method of operation. If the controls over or assistance to the franchisee's method of operation of the business are "significant", then this third element is met.

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. While the FTC may take the position that the presence of any one of these elements changes a license arrangement into a franchise arrangement, franchise practitioners see the presence of one or more of these elements not fatal but in the grey area or "Twilight Zone" between a true license arrangement and a franchise.

Significant Types of Control

1. Site approval for a yet to be established business;
2. Site design or appearance requirements;
3. Hours of operation;
4. Production techniques;
5. Accounting practices;
6. Personnel policies and practices;
7. Promotional campaigns requiring the franchisee's participation or financial contribution;
8. Restrictions on customers; or
9. Location or sales area restriction.

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

1. Formal sales, repair or business training programs;
2. Establishing accounting systems;
3. Furnishing management, marketing or personnel advice;
4. Selecting site locations; or
5. Furnishing a detailed operating manual.

In addition to the above listed elements - the presence of <u>any</u> 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;

(ii) Required displays of goods; or

(iv) On-the-job assistance in sales or repairs.

The following elements are <u>not</u> considered by the FTC 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.

The FTC will not interpret a supplier's assistance in a franchisee's promotional activities as “significant,” in the absence of additional forms of assistance. This includes assistance in furnishing a distributor with point-of-sale advertising displays, sales kits, product samples and other promotional materials intended to assist the distributor in making sales. It also includes assistance in connection with advertising in the media, whether provided solely by the franchisor or on a cooperative basis with its franchisees.

The FTC's interpretation of the term “significant” recognizes that significance also is a function of the degree of reliance which franchisees are reasonably likely to place upon the controls or assistance. Obviously, reliance is likely to be greater in circumstances where the franchisee is relatively inexperienced in the business represented by the franchisor, or where the relative financial risk assumed by the franchisee in relation to its total business is greater (*i.e.* adding a new product line which is intended to account for a substantial amount of the business' future sales or income compared to a modest amount), or where controls or promised assistance are unique to one specific franchisor as opposed to typical industry practices employed by all businesses in the same industry. Moreover, it should be emphasized that in order to be deemed “significant” the controls or assistance must be related to the franchisee's entire *method of operation*— not method of selling a specific product or products which represent a small part of the franchisee's business. Controls or assistance directed to the sale of a specific product which have, at most, a marginal effect on a franchisee's method of operating the entire business will not be considered in determining whether control or assistance is “significant.”

<u>The Single Trademark License Exclusion</u>

The Franchise Rule specifies 4 types of relationships that are not deemed to constitute franchises. One of these 4 is the single trademark license exclusion based on the FTC’s finding that trademark licensing arrangements typically involve very limited numbers of licensees and that the record contained no evidence to suggest that such licenses should be covered by the FTC Franchise Rule. Accordingly, the FTC Franchise Rule provides that the term *franchise* shall not be deemed to include any continuing commercial relationship created solely by an agreement between a licensor and a single licensee to license a trademark, trade name, service mark, advertising or other commercial symbol where such license is the only one of its general nature and type to be granted by the licensor with respect to the trademark, service mark, advertising, or other commercial symbol. 16 C.F.R. §436.2(a)(4)(iv).

<u>What if the License Arrangement is Held to be a Franchise?</u>

The obvious advantages of licensing over franchising include substantial lower legal costs, reduced accounting costs, no auditing costs, no registration in the franchise registration states and approval of the license program with such 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 (as later discussed) in states having business opportunity disclosure and registration laws. provided the mark is registered (federal or for certain states, a state-registered mark.)

The details of the FTC Franchise Rule and state franchise disclosure and registration laws are beyond the scope of this paper. Generally, any business arrangement meeting the 3 elements of a franchise under the FTC Franchise Rule requires the preparation of a pre-sale disclosure document called a “Franchise Disclosure Document” containing 23 items of information about the franchisor and the franchise offering, disclosure of the employment history, certain litigation and bankruptcy of its principals, the initial investment required including initial and ongoing payments to the franchisor and any affiliates, the respective rights and obligations of the franchisor and franchisee, list of existing and former franchises and a 3-year phase-in of audited financial statements. There is no registration with, or approval by, the FTC or any other federal agency.

Since the FTC Franchise Rule does not preempt state franchise laws, a franchisor must also comply with the franchise laws of various states. Fourteen states have adopted franchise registration and disclosure laws modeled after or deferring to the North American Securities Administrators Association, Inc. (“NASAA”) 2008 Franchise Registration and Disclosure Guidelines known as the Franchise Filing States.2008. The states require the registration with, and approval by, a state agency of the Franchise Disclosure Document. Florida is not a Franchise Filing State and does not have a franchise registration and disclosure law. Under Section 559.802 of the Florida Statutes, a franchisor is providing a safe-harbor or exemption from registering as a business opportunity seller under the Florida Sale of Business Opportunities Act (Chapter 559, Part VIII of the Florida Statutes).

Furthermore, certain states having business opportunities laws may require the franchisor to register as a business opportunity seller unless an exemption is available.

While these are obvious 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 compliance with the franchise laws began 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. While there is no private right of action for a violation of the FTC Franchise Rule (as only the FTC can enforce it), under the Florida Unfair and Deceptive Trade Practices Act (Chapter 501, Part II of the Florida Statutes), a person may bring an action for violation of the FTC Franchise Rule as the courts are required to give "due consideration and great weight shall be given to the interpretations of the Federal Trade Commission and the federal courts relating to s. 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. s. 45(a)(1) as of July 1, 2006." [Section 559.204(2) of the Florida Statutes]. This includes the FTC Franchise Rule (see *Nieman v. DryClean U.S.A. Franchise Co.*, 178 F.3rd 176 (11th Cir. 1999).

FTC Informal Advisory Opinions

Since the FTC Franchise Rule became effective in October 1979, the FTC has issued several Informal Advisory Opinions as to whether a license arrangement constitutes a franchise. A written advisory opinion is the one—and only—means provided under the Commission's Rules of Practice to obtain advice from the Commission or its staff on which any reliance may be placed. 16 C.F.R. §1 (1979). The advisory opinion procedure, which requires a request in writing, is a matter of public knowledge, having appeared both in the *Federal Register* and the *Code of Federal Regulations.* Copies are available, for the asking, from the Commission.

In **Con-Wall Corp., February 17, 1981**, the license agreement between a manufacturer of pre-cast concrete panels and its licensees was determined to a franchise solely based on the fact that the license agreement restricted a "license" to a specific geographical area and prohibited the licensee from operating outside the area. FTC found that this one restriction to be significant because it did not simply grant an exclusive area, but in addition, absolutely barred a licensee from conducting business outside the assigned area.

In **Permagraphics International, Inc., September 21, 1982**, a license agreement granting licensees the right to use the licensor's laminating process and laminating equipment for the production, merchandising, distribution and sale of laminated products but prohibited the use of the mark was construed to be a true license arrangement and not a franchise. The FTC stated that since the license agreement expressly prohibited the use of the licensor's marks, name or symbols, the commercial relationship lacked one of the essential definitional elements required to establish a franchise relationship under the FTC's Franchise Rule; therefore it is not covered by the Rule. However, the FTC also stated that if the licensor permits or encourages licensees to prominently display to their customers laminating equipment supplies or finished products which bear the licensor's mark, or to operate from facilities readily identifiable as part of a chain because of their common appearance or other features, coverage might result citing Informal Staff Advisory Opinion to U.S. Marble, October 9, 1980.

In **Informal Staff Advisory Opinion 94-7, October 18, 1994**, the FTC ruled that a license arrangement for the distribution of bottled water constituted a franchise due to the licensor's significant assistance including assistance to a licensee in the design, procurement of equipment, set-up, and initial operation of facilities in order to facilitate commencement of operation of the licensee's plant." The license agreement also provided for broad controls over many aspects of the licensee's method of operation including design standards on the type of bottles the licensee may use and specific bottling procedures. The license agreement also restricted the licensee's purchase of equipment and supplies and reserved the right of the licensor to impose minimum prices for beverages, to the extent permitted by applicable law. The licensees were also required to maintain records and books for 6 years showing the quantity, description, and price of licensed products manufactured, sold, and transferred by the licensee. The FTC noted that these types of controls and assistance are more than sufficient to constitute a marketing plan.

In **Informal Staff Advisory Opinion 95-8, August 29, 1995**, a revised license agreement between an experience hotel owner and a hotel management company whereby the management company would reservation assistance to the hotel owner, as well as sales and advertising assistance but would not continue to manage the hotel was not considered a franchise. The FTC concluded that based on the nature of the hotel owner, the long involvement of the owner in the operation of the hotel, and the limited role that the management company would assume in the future operation of the hotel, the revised license agreement did not appear to satisfy the Franchise Rule's significant control and assistance requirement.

Conclusion

To develop and implement a true license program, these types of assistance and controls discussed above 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. If there is any doubt as to whether the business arrangement is a true license and not a franchise, it is advisable to obtain an informal advisory opinion from the FTC.

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