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Crossing the Line: When Licensing Becomes Franchising

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By *Lee Wright* of **Kirton McConkie**

Over the last several years, we have helped clients "clean up" after the relationships they designated as "licenses" or "distributorships" were viewed as franchising relationships by state regulators. Many business owners believe they can skirt franchising laws by merely licensing their business to another party. They are wrong -- and could face fines and prosecution if caught.

This is the usual pattern: a company with a product or service wishes to expand, finds individuals who like what the company offers and signs them up under a simple license agreement or distribution agreement. In the agreement, the company gives the individual the right to use the company trademark or brand for marketing and usually charges an initial fee for trademark use or other assistance. There is usually an ongoing payment such as a monthly or annual fee, a true percentage of sales like a royalty or a minimum purchase requirement.

As the relationship proceeds, the company sees new licensees struggling with operational issues or needing back office support. Wanting the licensee or distributor to succeed, the company gets involved with additional guidance or instruction. Sometimes the company even provides an operations manual outlining how to succeed.

Occasionally the nature and level of company support, branding, and compensation develop over time in ways the company may not have anticipated. It often is not the company's intention to develop such an involved licensing or distribution support system (or at least that is what the company says when challenged for developing franchise relationships). In other instances, the company simply fails to recognize when the line was crossed between licensing and distribution and when they are up to their necks in a franchising arrangement. The unfortunate reality is often legal counsel has helped them into the mess, claiming to know how to avoid a franchise relationship or simply writing license or distribution agreements without understanding when a relationship becomes a franchise.

If a licensing or distribution relationship includes three elements--use of a trademark or brand, operations or marketing support, and compensation of more than \$500 during the

first six months of the relationship, then it is likely a franchise and should meet the disclosure and registration requirements pertaining to franchise relationships.

When a company has established a franchise unknowingly, failed to properly disclose their franchisees with a Franchise Disclosure Document (FDD) and failed to register their franchise and documents with states requiring registration, it can face stiff fines and prosecution and must offer its franchisees a right of rescission, which means reimbursing all costs incurred in entering into the franchise relationship such as initial fees, royalties, build-out costs, and equipment costs--a very costly error for the accidental franchisor. In our experience, franchisees doing well are not usually interested in invoking the rescission rights, but it must be offered. Franchisees struggling or having second thoughts, however, will generally invoke the rescission.

After negotiations with the state, clearing up registration requirements, offering franchisees rescission rights and agreeing to pay state fines, the issue can be resolved and the company can proceed as a franchisor (although a disclosure is required in the FDD outlining the company violated state requirements).

For those who inadvertently become a franchisor, it is better to self-correct than get caught. There are ways to ask for leniency from regulators by explaining the situation and pleading for mercy. Though fines may still be involved, they typically won't be as large.

We caution you (or your clients) to pay attention to the nature of the license or distributorship and the three elements that define franchise relationships. Regardless of your business model, you should know and understand the line between licensing/distribution and franchising, the risks and penalties of crossing the line, and how to handle problems if they arise. When in doubt about your business model, contact legal counsel with sound experience in franchising.

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