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Regulatory: The 3 criteria of an accidental franchise

An intended trademark license might legally be a franchise if it meets these qualifications

BY RANDY JOHNSON
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Companies that market their goods or services through independent distributors may be surprised to learn their distributorship arrangement is in fact a franchise subject to federal and/or state regulation. Similarly, what may seem like a simple trademark license often crosses the line into franchise territory.

Franchise relationships are governed at the federal level by the so-called Franchise Rule, regulated and enforced by the Federal Trade Commission. A slight majority of states have some form of franchise law or business opportunity statute. What constitutes a franchise or a business opportunity subject to these federal and state regulations is determined by the nature of the relationship, not by the label given to it by the parties.

The complexity of modern commercial relationships has led to an increasing number of accidental franchises—that is, commercial relationships not intended to be franchises, but which inadvertently fall within the broad reach of the franchise or business opportunity laws. Manufacturers or suppliers who distribute their trademarked goods or services through independent agents or licensees may easily cross the line separating ordinary business relationships from franchises.

Simply put, a business arrangement is a franchise or a business opportunity if it meets three basic criteria:

1. The right to use a trademark in connection with the offer, sale or distribution of goods or services

2. The payment of more than $500 during the first six months of the relationship
3. Significant assistance to, or control over, the business of the person granted the right to use the trademark, which often takes the form of a prescribed marketing plan.

Regardless of whether the parties intend the arrangement to be a distributorship, a license or some other relationship, if it meets each of the above three criteria, it will be deemed a franchise or a business opportunity. For example, a simple trademark license in which the licensee pays more than $500 during the first six months will be considered a franchise if the licensor provides the licensee with a marketing plan or significant assistance. Similarly, a distribution agreement in which a distributor pays a manufacturer a fee of more than $500 and in which the manufacturer provides training, an operations manual, site selection assistance or marketing materials may be considered to fall within the purview of the franchise laws.

Among other requirements, the Federal Franchise Rule requires the franchisor to deliver to the potential franchisee a written Franchise Disclosure Document similar in scope to a prospectus used to sell securities. The requirements of state laws range from disclosure requirements to registration requirements.

Failure to comply with applicable federal and state franchise and business opportunity laws, whether such noncompliance is intentional or accidental, can have significant consequences. For example, each of the licensees or distributors in an accidental franchise may have the right to rescind the relationship, in which case the franchisor will be required to reimburse the licensee or distributor for all costs incurred in entering into the relationship, including license fees, royalties, build-out costs and equipment costs.

Knowing the elements of a franchise and being aware of the line that separates a license or distributorship relationship from a franchise will allow the parties to avoid the unwanted results of an accidental franchise.

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