Yearbook
2021/2022
A global guide for practitioners

Franchising and trademarks: where, why and how?

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For many trademark practitioners, franchise laws are an inconvenience. The knee-jerk advice to clients is to avoid franchising. This is not always bad advice, as compliance can be costly and cumbersome and franchise laws are often complex, intentionally broad and carry significant penalties. However, in many jurisdictions it is challenging, if not impossible, to allow a third party to replicate your business without becoming a franchisor, so it is helpful for trademark attorneys to understand when a trademark licence may cross the line.

Franchise definitional elements

All franchise agreements are trademark licences, but not all trademark licences are franchise agreements. Although the statutory language varies among jurisdictions, a classic franchise has three core elements:

- The licensor grants the licensee a right to use licensor's trademark.
- The licensee pays the licensor a fee, other than the wholesale price of resalable inventory.
- The licensor provides substantial assistance to the licensee, has the right to exercise substantial control over the licensee's methods of operation, or the licensor proscribes a marketing plan or system for the business.

In the United States, a licensing relationship that includes all three of these elements is a franchise, even if the parties explicitly disclaim that it is a franchise. Franchise laws constitute consumer protection laws and cannot be waived.

The US Federal Trade Commission has explained the difference between a licensor and a franchisor:

- a licensor cares about the end product or result; and
- a franchisor cares about the method of producing that result.

A licensor of roofing tiles might grant a company the right to use its marks, buy tiles and install them, and the licensor would focus only on whether the tiles were installed properly at the end of the job. A franchisor of a roofing-tile company cares about the final results, but also about the rest of the licensee's operations, such as whether the employees are prompt and courteous or offer various tile options and upgrades. These controls over how the licensee gets its job done tend to be the difference between a trademark licence and a franchise.

This is the core reason that many would-be licensors are in fact franchisors. When the goal is business replication, most licensors conclude that a large number of operational controls are required in order to preserve the licensor's goodwill. Customers may stop coming to the licensor's business if the employees at the licensee's identically named business are

not polite and knowledgeable, if the facility appears dirty or disorganised, or if they are not reliably open during normal hours.

Even in instances where the licensor can limit its ability to control, in most business replication scenarios the licensor will be called on to provide, or at least make available, substantial assistance. A typical licensee who wants to establish a business that is just as successful as the original expects detailed operations manuals, hours of training, recipes, formulas, participation in shared loyalty programmes or other guidance and access that will allow that licensee to duplicate the licensor's operations. Either meaningful training or the provision of access to tools or platforms such as a mobile application, point-of-sale system, use of the licensor's website or similar elements could constitute enough assistance to constitute the third element.

Countries with franchise laws

As franchising has gained popularity and momentum in the past century, franchise laws have proliferated. These laws now exist in North America (Canada, the United States and Mexico), South America (Brazil), Europe (Belgium, France, Italy, Romania, Spain and Sweden), Asia (China, Indonesia, Japan, Korea, Macau, Malaysia, Taiwan and Vietnam), Africa (South Africa) and Australia. In addition, many countries have specific disclosure or registration laws applicable to trademark licences that also apply to franchise relationships.

Before expanding into a new country, it is vital to review the applicable laws that might govern the relationship and determine what franchise-specific or trademark-specific steps must be taken to ensure compliance with local requirements.

Franchise law compliance

Franchise law compliance varies by jurisdiction. However, US laws have been the blueprint for many other jurisdictions' disclosure laws and may be instructive. In the United States, franchisors are required to provide franchisees with a due diligence packet known as a 'franchise disclosure document' (FDD), consisting of 23 required elements of disclosure. These disclosures are detailed and specific, ranging from information about the franchisor (including audited company financials, disclosures of the company's and its executives' recent litigation and bankruptcy histories, and company revenue derived from franchisee purchases) to information about the total amount of money that a franchisee should expect to spend to develop their own unit of the offered business and all of the fees that the franchisor will, or has the right to, charge the franchisee over the course of the relationship. The FDD also requires the franchisor to disclose contact information of franchisees, including those who have recently left the system, so that prospective franchisees can contact them and ask about their experiences.

The structure and required information are intended to give the prospective franchisee significant insight into:

- whether the system is growing or shrinking;
- whether the system has a high turnover;
- whether the franchisor is financially healthy; and
- what controls the franchisor will have over the franchisee's business.

One of the most important rules under US law is a prohibition on the franchisor making any representation of what the franchisee could earn unless they provide that information in writing within the FDD, calculated in compliance with specific rules. A franchisor with four franchisees in its system, one of which earns a million dollars a year while the other three each earn $250,000 a year, cannot represent to a prospect that it is 'likely' to earn more than $500,000, even if the franchisor believes that its three lower producing franchisees are lazy, inept or not following the system. This restriction on financial performance representations or 'earnings claims' can significantly affect how a franchisor may sell its concept.

US law requires a franchisor to update its FDD each year and to keep it updated periodically throughout the year. This requirement, as well as annually replacing information regarding the past fiscal year with new information from the most recent year, adds cost. In addition, numerous US states, including California, New York, Illinois and Washington, each require the franchisor

to register an FDD with the state each year before engaging in sales. Each state's franchise regulatory personnel review the FDDs before granting a permit to sell, which adds expense and can delay the sales timeline, sometimes by months.

Finally, material changes, such as the departure of a key manager or the filing of a significant lawsuit against the company, can require the franchisor to stop selling and update (and re-register) their FDD as applicable. All these regulatory challenges are reasons that many businesses opt to avoid franchising.

Franchise benefits and key considerations

So, why franchise if it is complicated and requires substantial attention to regulatory issues? First, many businesses seeking to license a third party to use their trademarks and know-how have no other choice. The terms of their preferred licence agreement create a franchise and, consequently, they must comply with franchise laws.

Second, franchising is a relatively affordable way to expand a business using others' capital, without losing control of the underlying intellectual property. A licensor who cannot afford to open more than one new unit per year on its own, and who does not want to give an ownership share to a third-party investor (eg, a partner or private equity firm) in order to raise more capital, can launch a franchise initiative and potentially open a dozen or more new units under its trademark and system within a year. While having no liability for payroll, leases or construction loans of any of those new businesses, the franchisor can collect a royalty from each one and continue to invest in both expansion and research and development to keep its concept ahead of competitors. While the franchisees have a right to use the trademarks and other intellectual property during the term of their franchise, including any renewals, at the end of the relationship the franchisor still owns the trademarks and the know-how. Under the terms of a typical franchise agreement, the franchisor even acquires the ownership of innovations that the franchisee may have made while operating the franchised business. In one famous example, a McDonald's franchisee invented the now iconic Egg McMuffin.

A founder or business considering franchising should ask themselves a few key questions:

- Have I already practised replicating my business?
  - While it is not mandatory to have more than one business unit before franchising, most people learn a lot about what is most important to their business concept by creating at least a second unit, if not more. Having multiple units allows the owner to test size, location, demographics, managerial styles, training systems, operations manuals, product or service

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offerings, as well as other elements. The risk with franchising a single unit is failure to recognise the most critical elements to the success of that unit.

- Am I prepared to take on franchising as a full-time job?
  - Many start-up franchisors are under the impression that franchising can be a side hustle, and after offering some training and handing over an operations manual, the work is done and all that is left is to collect the royalty payments – but nothing is further from the truth. The average franchisee buys a franchise with the expectation that they are getting a 'business in a box' and that the franchisor will have solutions to all the business challenges and will continue to innovate to ensure that the system remains as prominent as it was the day that the franchisee first invested. A strong franchise system typically requires multiple people engaged on a full-time basis in a blend of sales, training, operational support, marketing, research and development and quality review. A start-up may house all these roles in a single founder, but that founder will need to hand over operation of their original unit to other managers so that they can focus their full attention on cultivating the franchise system.
- What sets my business apart from others, and am I prepared to keep innovating to preserve those advantages?
  - Franchisees are seeking a business that will provide them a good income and that will be a good long-term investment for themselves and, often, their families. They expect that their franchisor will devote significant time, energy and money to promoting the trademarks and developing exciting offers that will attract and retain customers. A business owner who happens to have a successful business simply because it is the only pizza restaurant within a particular suburb does not necessarily have the components to help a franchisee replicate that success. Although no franchisor guarantees success, the successful franchisor will continuously focus on the elements that set it apart from competitors in all the markets where it operates or franchises. It will also keep in mind that without marketing and innovation it is likely to be overtaken by the next trend or a well-financed competitor, meaning that its franchisees will sour, leave the system and discourage others from joining. A successful franchisor is focused on keeping its brand fresh and relevant and on listening to its franchisees' concerns.

Cross-border franchise issues

As we know from many systems that operate around the world (eg, McDonald's), numerous franchise systems exist in multiple countries. When confronting an international expansion, franchise systems face many of the same challenges as non-franchised businesses do, as well as some novel concerns. Franchisors will need to think about their supply chains and whether their concept requires any modifications to be embraced in a foreign jurisdiction. They also need to determine the tax implications of collecting royalties and

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other revenue from international jurisdictions where they do not operate, and the implications of sending regional managers to complete quality inspections in other countries. In many instances, franchisors will sell a local entity the right to act as a regional franchisor, in an arrangement known as 'sub-franchising' or 'master franchising'. The sale of that master franchise alone may be subject to disclosure requirements, so a franchisor seeking to avoid franchise disclosure compliance in a foreign country by sub-franchising may still need to wrestle with compliance at least once, depending on local laws. Further, in some countries, franchisees will have rights to sue in local jurisdictions, so the franchisor should consider its exposure and liability in countries where it does not operate before committing to expansion.

Franchise exemptions or avoidance

One of the most common questions posed to most franchise practitioners is 'but surely there's a way to avoid all this compliance work?' The answer is often complex. Franchise laws cannot be avoided by mere waiver or disclaimer. If the licensor can find a way to eliminate one of the three elements of a franchise, it is not a franchisor. Thus, many sellers of goods require distributors to purchase inventory, but do not collect any other fees; they may provide required uniforms and sales demonstration kits for free, and require the licensee to buy marketing brochures from an unaffiliated third party. By charging the licensee nothing except wholesale prices for resalable inventory, the licensor avoids the fee element.

Other systems acknowledge that they are franchises but use exemptions available in the United States. For example, in most US jurisdictions, a sale to a prospective franchisee with a net worth exceeding $6,165,500 (this is adjusted every four years) does not require disclosure. It is presumed that such a large entity can request its own due diligence. Another exemption is the 'fractional franchise', which results when an existing business invests in a franchise that will make up a small portion of its ongoing revenue – a typical example is a hotel owner adding a coffee shop to its lobby.

The challenge with exemption-based franchising in the United States is that the federal and state laws do not have identical exemptions. Therefore, an exemption-based franchise system must:

- limit sales to situations where an exemption applies and avoid sales in particular jurisdictions where no applicable exemptions exist; or
- it may use exemptions in some jurisdictions but prepare a compliant FDD and provide disclosure in others.

Penalties

Franchise law violations often carry heavy penalties. In the United States franchise law violations can be felonies and the individuals culpable for the wrongful acts (eg, misleading disclosures or failure to register) are liable, despite the corporate shield. Many state agencies respond aggressively to consumer reports of fraudulent conduct and issue heavy monetary fines and require the offer of rescission and permanent disclosure of the prior violation in the future.

In most instances, an accidental franchisor who has inadvertently created a franchise while only intending to license, or who has made a misrepresentation to a franchisee, should self-report the violation rather than wait to see if a state agency discovers it. Regulators are more lenient with those who self-report and are significantly more likely to work collaboratively with the franchisor. Use of an experienced attorney to guide the self-reporting process is valuable. WTR

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