Disguised Franchises: The License Agreement Trap

by Allison S. Becht

Despite the ubiquity of franchised businesses throughout New Jersey, the practice area relating to such businesses remains an understudied concept among corporate attorneys. It is important for corporate attorneys to become more familiar with the franchise rules in the applicable jurisdiction. The operation of an illegal or disguised franchise can not only result in civil or criminal liability for the client, but even a typically diligent attorney may face claims of malpractice when a licensing arrangement is subsequently found to be a legally regulated franchise relationship. This article addresses some of the common issues and pitfalls that may arise in the licensing/franchising context, and of which corporate counsel should be aware, namely what a franchise is and the ramifications of being identified as one.

What is a Franchise?

In the vernacular sense, a franchise is a business relationship where a trademark holder licenses another the right to use its trademark, for a fee, in connection with common business operations. The trademark holder is referred to as the 'franchisor' and the person or entity receiving the licensed rights is dubbed the 'franchisee.' Typically, in a franchise relationship there is a written agreement commonly entitled a franchise agreement that defines the rights of the parties. Notwithstanding what the parties might entitle the legal agreement among them (*e.g.*, license agreement, joint venture agreement, distributor agreement, dealership agreement), the agreement may implicate both federal and state law governing franchises and the sale and/or termination thereof. In evaluating whether a franchise relationship exists, government regulators and courts alike focus on form over substance. Simply put, "if it looks like a duck and it smells like a duck and it quacks like a duck, it's usually a duck."[1]

As an initial matter, it is important to understand how a "franchise" is defined under applicable law. The Federal Trade Commission (FTC) defines a franchise as a "continuing commercial relationship" that meets certain conditions, "whatever it may be called."[2] According to the FTC, each of the following elements must be present in order for a business relationship to be deemed a franchise for purposes of federal law:

> (1) The franchisee must obtain the right to operate a business that is identified or associated with the franchisor's trademark, or the right to offer, sell, or distribute goods, services, or commodities that are identified or associated with such trademark;
>
> (2) The franchisor must exert a significant degree of control over the franchisee's business operations, or provide significant assistance in the franchisee's method of operation; and
>
> (3) As a condition to obtaining or commencing business operations, the franchisee must make a minimum payment of at least $500, or commit to make such a required payment, to the franchisor or its affiliate.[3]

In short, a franchise relationship exists when there is a trademark, control, and required payments to the licensor. If each of these three elements exist, full compliance with the federal disclosure requirements set forth in 16 C.F.R. § 436 (the FTC rule) is required.

When Will a Licensor be Deemed a Franchisor?

It is possible that an attorney somewhere is reading this article and realizing that his or her client may, in fact, be a disguised franchisor—or that the licensing documents that he or she is in the midst of preparing are for the type of business relationship that would satisfy the three requirements identified above. By counseling clients on the reach of the FTC rule and ensuring the business relationship at issue does not satisfy all three elements of the FTC rule, the attorney can reduce the likelihood that his or her client will be subject to the franchise disclosure laws and the consequences that stem from non-compliance.

For starters, if there is no common trademark, it will

be difficult to prove that a franchise exists. The question of commonality, however, is based less on the intent of the licensor and licensee and more on the perception of the public.[4] Courts will look to see if the licensee reasonably believed that customers would perceive a substantial association between the licensee and the licensor.[5] If a licensee substantially uses the licensor's trademarks to conduct business, there will be a good chance that the first element of the FTC rule will be satisfied. Ultimately, the best protection for a licensor who wishes to avoid the first prong of the FTC rule analysis is to contractually prohibit the licensee from using the licensor's marks, and to strictly enforce any such prohibition.[6]

Similarly, a client can remain outside the scope of the FTC rule by avoiding the 'significant control' requirement. As a matter of practice, if a licensor wants to avoid being inadvertently deemed a franchisor according to the FTC's definition, the licensor should try to exert as little control as possible over the licensees' business operations and provide as little assistance to the licensee as possible. Assistance to the licensee can come in a variety of ways, including, for example, selecting/approving site locations, training employees, setting hours of operation, assisting with marketing and promotional campaigns, establishing accounting systems, and advising as to personnel policies.[7] Licensors walk a fine line with respect to the element of control—while providing limited assistance and avoiding such control "is possible in theory, the practical reality is that almost any assistance or control could conceivably meet the assistance or control element."[8] Every licensor likely will want to—or need to—exert a certain degree of control over the licensor to protect the goodwill of its trademarks.

The final element of the FTC rule analysis is that of 'required payment.' The FTC's objective in interpreting the required payment factor is to capture all sources of revenue that a franchisor or its affiliate receives from the licensee in connection with the trademark license or the right of the licensee to associate with the licensor in the sale or provision of its goods or services.[9] A required payment is not limited to a simple franchise fee, but may include any other type of payment that a licensee is required to pay to the licensor or its affiliate—whether by contract (*i.e.*, payments pursuant to the license agreement or a real estate lease agreement) or by practical necessity (*e.g.*, payments for supplies, inventory or equipment that are required by the licensor and can only be obtained from the licensor or its affiliate).[10]

Responsibilities of Franchisees

Once a business relationship is determined to be a franchise, the franchisor is obligated to comply with the FTC-mandated disclosure requirements. The franchisor's principal obligation is to provide potential franchisees with a franchise disclosure document (FDD). A FDD can take months to prepare and cost a company thousands of dollars in legal fees.[11] Among other things, a FDD is required to contain certain delineated information about the franchise offer and the following 23 items:

1. Detailed information about the franchisor and its business;
2. The names and positions of any management-level individuals within the franchisor's business;
3. Past and/or pending litigation;
4. Past and/or pending bankruptcy litigation;
5. All initial fees relating to the purchase of the franchise;
6. Any other fees that a franchisee may or will be obligated to pay to the franchisor;
7. The total estimated initial investment;
8. Any restrictions on products and services;
9. The franchisee's obligations;
10. The terms of any financing agreement;
11. The services and obligations of the franchisor;
12. The territory of the proposed franchise;
13. Any trademarks that will be licensed to the franchisee;
14. Any patents, copyrights, or proprietary information owned by the franchisor;
15. The obligations of the franchisee to participate in the actual operation of the franchise;
16. Any restrictions on what the franchisee may sell;
17. Renewal, termination, transfer, and dispute resolution clauses;
18. Any endorsements given by the franchisor to public figures;
19. Financial performance representations of the franchise;
20. The total number and names of any existing franchisees;
21. Financial statements from the previous few years;
22. Any proposed contracts regarding the franchise;
23. Acknowledgment of receipt of the FDD.[12]

It is a violation of the FTC rule for a franchisor to sell—or even offer to sell—franchises without the required FDD in place. Such a violation not only subjects the franchisor to a number of civil and criminal penalties under the FTC rule, but the failure to make

the appropriate disclosures can also be considered an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act.

Although New Jersey does not require franchisors to register their FDDs or franchise opportunities with the state—like some other states do[13]—the failure to have a compliant FDD may be a violation of the New Jersey Consumer Fraud Act, in which case the franchisor would have to contend with the possibility of treble damages.[14]

New Jersey Franchise Practices Act

The rules promulgated by the FTC are applicable in every jurisdiction. However, like many other states, New Jersey has enacted additional laws to regulate the operation of franchises. The New Jersey Franchise Practices Act (NJFPA)[15] is a franchisee-protective statute that is designed to establish a more balanced franchisor/franchisee relationship.

Franchisors subject to the NJFPA should be wary that the protections afforded by statute cannot be released or waived by contract, as it is a strict violation of the statute to require franchisees to agree to any such release or waiver.[16] Because of New Jersey's public policy in favor of protecting franchisees, courts will invalidate choice-of-law provisions that are included in an attempt to circumvent the NFJPA.

The NJFPA applies to a wide range of business associations in New Jersey—even if the parties to the relationship do not intend to establish a franchise relationship. Under the NJFPA, a franchise is defined as a "written arrangement for a definite or indefinite period, in which a person grants to another person a license to use a trade name, trade mark, service mark, or related characteristics, and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise."[17] Once a business is determined to be a franchise under New Jersey law, the following additional requirements must be satisfied in order for the NFJPA to apply:

> the performance of the franchise contemplates, or requires the franchisee to establish or maintain, a place of business within the State of New Jersey;
>
> the gross sales of products or services between the franchisor and franchisee covered by such franchise shall have exceeded $35,000.00 for the 12 months next preceding the institution of suit pursuant to the NJFPA; and
>
> more than 20% of the franchisee's gross sales are intended to be or are derived from such franchise.[18]

While the FTC regulations are already inherently broad, the NJFPA definition of a franchise is perhaps even broader. For any business that falls within the three NFJPA-specific categories, there are responsibilities above and beyond those required by the FTC, the failure to abide by which can impose additional layers of liability.

Among other things, it is a violation of the NJFPA to prohibit the free association among franchisees, require any change in the franchisee's management, or impose unreasonable standards of performance.[19] In addition, the NJFPA restricts the franchisor's ability to withhold its approval of a sale or transfer of the franchise—the franchisor bears the burden of proving that there are "material reasons" for which the proposed transfer should be denied.[20] Finally, and perhaps one of the frequently litigated NJFPA-related issues, is that it is a violation of the NJFPA to explicitly or constructively cancel or terminate, or even fail to renew, a franchise without "good cause." Good cause requires a material breach of the franchise agreement by the franchisee.[21]

Liability Resulting from Franchise Violations

If a company is found to be operating a disguised franchise and does not otherwise comply with the federally mandated disclosure requirements, or is in violation of any of New Jersey's franchisee-protective laws, it will be subject to liability.

The FTC rule does not create a private right of action for aggrieved franchisees who believe their franchisors have violated federal law. However, the FTC is given broad discretion to enforce the FTC rule and has at its disposal a number of tools to police unfair methods of competition and/or unfair or deceptive acts or practices in or affecting commerce. The FTC may commence civil actions against franchisors that have violated the FTC rule and recover up to $10,000 per violation.[22] In addition, the FTC can issue cease and desist orders against such franchisors, and any continuance of violations after such orders are issued will be treated as separate violations for purposes of the $10,000 per violation limit.[23]

Unlike its federal counterpart, the NJFPA provides

franchisees with a private right of action. Any aggrieved franchisee covered by the NJFPA may bring an action for damages or injunctive relief against its franchisor—even an illegal or disguised one—if it violates the NJFPA.[24] New Jersey does not have a limit on damages. Moreover, successful franchisees are entitled to reimbursement for the costs of the action, including, but not limited to, reasonable attorney's fees.[25] In one New Jersey case, the constructive termination of a franchise in violation of the NJFPA resulted in a judgment of $4,514,848.25, including attorney's fees and costs.[26]

New Jersey is not the only state with harsh penalties if a company violates applicable franchise laws. Several other states have just as strict penalties for failing to comply with state-mandated laws relating to franchising.[27] Thus, it is important for corporate attorneys to be especially diligent in this area and ensure that their clients are complying with the federal and state franchise laws, if applicable. ■

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Endnotes

1. N.Y. Gen. Bus. Law § Ch. 20, art. 33, Refs & Annos (McKinney).
2. 16 C.F.R. § 436.1(h).
3. *Id.*
4. *See Neptune T.V. & Appliance Serv., Inc. v. Litton Microwave Cooking Prods. Div., Litton Sys., Inc.*, 462 A.2d 595, 599 (N.J. Super. Ct. App. Div. 1983) (finding authorization to use a party's name sufficient to create a license under the New Jersey Franchise Practices Act because it was sufficient to induce the public into the uniform acceptance that there was a connection between the parties).
5. *See Colt Indus. Inc. v. Fidelco Pump & Compressor Corp.*, 844 F.2d 117, 123 (3d Cir. 1988) (stating that a licensor might create a reasonable belief among consumers that a connection exists between the licensor and licensee any number of ways, including the performance of warranty repair services).
6. *See* Powerbrand Prods. of Va., FTC Informal Staff Advisory Opinion, 2 *Bus. Franchise Guide* (CCH) P 6438 (May 13, 1983) (stating that express prohibition of the use of the supplier's mark by the distributor avoids coverage under the rule); *see also* 2 *Bus. Franchise Guide* (CCH) P 6433 (Sept. 21, 1982) (stating that because the licensing agreement at issue expressly prohibited the use of the licensor's marks, the relationship between the parties "lack[ed] one of the essential definitional elements required to establish a franchise relationship" under the rule); U.S. Marble, Inc., FTC Informal Staff Advisory Opinion, 2 *Bus. Franchise Guide* (CCH) P 6424 (Oct. 9, 1980) (explaining that a prohibition against using a seller's marks must be expressly stated in a contract, and that the use of contractual silence is not enough).
7. Mark H. Miller, Unintentional Franchising, 36 *St. Mary's L.J.* 301, 320 (2005).
8. *Id.*
9. *See* Final Guides to the Franchising and Business Opportunity Ventures Trade Regulations Rule, 44 Fed. Reg. at 49,967 (Aug. 24, 1979) (discussing the FTC's intent to capture all hidden franchise fees).
10. *See id.*
11. *See* 16 C.F.R. § 436.3.
12. *See id.* at § 436.5.
13. The registrations states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Of course, if a client is licensing its trademarks and/or business system across state borders, the attorney should be especially mindful of the application of the other states' statutes. Failure to do so could result in a malpractice claim.
14. *See Morgan v. Air Brook Limousine, Inc.*, 211 N.J. Super. 84 (1986); *Kavky v. Herbalife Int'l of Am.*, 820 A.2d 677, 684–85 (N.J. Super. Ct. App. Div. 2003).
15. *See* N.J. Stat. Ann. § 56:10-1.

16. *Id.* at § 56:10-7(a).
17. *Id.* at § 56:10-3(a).
18. *Id.* at § 56:10-4.
19. *Id.* at § 56:10-7(b), (c), (e).
20. *Id.* at § 56:10-6.
21. *Id.* at § 56:10-5.
22. *See* 15 U.S. Code § 45(m)(1)(A).
23. *See id.* at § 45(m(1)(C).
24. *See* N.J. Stat. Ann. § 56:10-10.
25. *See id.*
26. *See Maintainco, Inc. v. Mitsubishi Caterpillar Forklift Am., Inc.*, 2009 WL 2365960, at *1 (N.J. Super. Ct. App. Div. July 30, 2009) (resulting in compensatory damages of $734,000, attorney's fees of $3,533,642.50, and costs of $247,205.75, excluding expert fees).
27. *See* Cal. Corp. Code § 31405 (West) (limiting California civil liability to $10,000 per violation); Md. Code Ann., Bus. Reg. § 14-227 (West) (indicating civil liability in Maryland); N.Y. Gen. Bus. Law § 690–691 (McKinney) (listing both civil and criminal penalties in New York).