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OMG: I have licensed my Trademark and Now I am a Franchisor!

A company's trademark or brand name is often a valuable asset. A company may capitalize and exploit its trademark by licensing the use of the mark to third parties. There may be up-front costs to the licensor, but the royalty stream may be substantial and continuous since the life of a trademark can be forever. However, when licensing its trademark, a company may have unknowingly created a franchise. This is known in the industry as an accidental franchise.

What is a franchise? A franchise is a regulated relationship for which pre-agreement disclosure is required under federal and certain state laws and also which may be limited in certain circumstances over the life of the relationship and beyond by various state laws. While the trademark owner sometimes makes a strategic decision to create a franchise, more often, the creation of a franchise relationship is an unintended consequence of a combination of elements in the structure of the business relationship, which causes it to fall within the legal definition of a franchise.

For example, if a licensor intends to grant an ordinary trademark license, the licensor must be careful not to include certain terms in the license agreement that may result in the trademark agreement being construed as a franchise agreement. Significant federal and state franchise regulations govern business relationships that fall within the legal definition of a franchise - everything from the initial offer and sale of franchises to the use of prescribed disclosure documents and prescribed procedures, to regulating the relationship of the franchiser and its franchisees up to and through the termination of the franchise relationship.

So when is a trademark license a franchise agreement? In general, a business relationship is a franchise under federal and state law when the following three terms in the agreement exist together: (1) The right to use a trademark to offer, sell or distribute goods or services (the trademark element), (2) Payment of a required fee (the fee element) and (3) Significant assistance or control with respect to the franchisee's business, which may take the form of a marketing plan (the assistance element). In order to avoid coming within the legal definition of a franchise and thereby become subject to regulation under federal and state franchise laws, a licensor must not include more than two of the three elements in its licensing agreement. Most trademark license agreements include elements (1) and (2), so whether the licensing agreement creates a franchise relationship depends upon element (3).

Nonetheless, even if all three elements are present, there may be exceptions to the creation of a franchise relationship. For example, under the "fractional" franchise exception, when an existing business adds a franchised product or service to its other lines of business, such business arrangement does not trigger the franchise regulations if (1) the franchisee

has more than two years of experience in the same type of business; and (2) the parties have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20% of the franchisee's total dollar volume in sales during the first year of operation.¹ Another example is the "single license" where a single trademark license is exempt from the federal disclosure requirements. To be entitled to this exemption, there must be only one licensee who is granted the right to use the licensor's trademark.

The first indication that an accidental franchise has been created is often receipt of a cease and desist letter from a state regulator who has received a complaint of a sale of a franchise without proper disclosure. An accidental franchise can create huge penalties for franchisors, both civil and criminal. Further, a franchisor may be required to permit the franchisee to rescind the agreement. In order to ensure that a trademark licensor does not create an accidental franchise, the licensor should consult franchise counsel before pursuing a licensing program.

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¹ 16 C.F.R. § 436.8(a)(2) (2007).