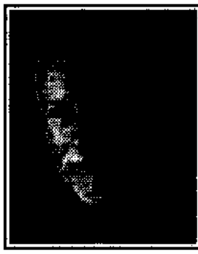

It's All About the Trademark

By Howard Caplan

A central and defining element of a franchise system, in nearly every case, is the licensing of a trademark. Indeed, in *Susser v. Carvel Corporation,* 206 F.Supp. 636 (S.D. N.Y. 1962), *aff'd,* 332 F.2d 505 (2nd Cir. 1964), the court opined that "the cornerstone of a franchise system must be the trademark or trade name of a product. It is this uniformity of product and control of its quality and distribution which causes the public to turn to franchise stores for the product." *Id.* at 640. Although *Susser* was an antitrust case involving tying and product pricing, the Second Circuit nevertheless expressly acknowledged the lower court's "trademark as a cornerstone" statement. Indeed, the fact that franchisors require franchisees to use the franchisor's marks, in particular the franchisor's name, is a major factor in the growth of a franchise and its goodwill. Hence, the plethora of cases addressing trademark control in post-termination situations. *See generally* Ann Hurwitz & Rochelle B. Spandorf, *Building Franchise Relationships,* 239-244 (American Bar Association, 1996).

Franchisors Without a Federally Registered Mark

While the new FTC Franchise Rule defines a franchise, in part, as being "associated with the franchisor's trademark," *see* 16 C.F.R. § 436.1 (h)(1), it does not require that the franchisor's trademark be registered as a condition of the offer and sale of a franchise-or in fact that it ever be so registered Similarly, the majority of the registration states define a franchise, in part, as being "substantially associated with" the franchisor's trademark.

The FTC Rule, like the old UFOC format, requires disclosure of the status of any pending trademark registration application with the PTO. But the UFOC Guidelines required the franchisor to state:

> By not having a Principal Register federal registration for (name or description of symbol), (Name of Franchisor) does not have certain presumptive legal rights granted by a registration.

The new FDD requires the following disclosure:

> We do not have a federal registration for our principal trademark. Therefore, our trademark does not have many legal benefits and rights as a federally registered trademark. If our right to use the trademark is challenged, *you may have to change to an alternative trademark, which may increase your expenses.*
>
> Item 13A Instructions iii, *Uniform Franchise Offering Circular Guidelines General Instructions;*16 C.F.R. § 436.5 (m)(4) (emphasis added).

Examiners and other representatives from registration states with whom the author has communicated have indicated that the lack of registration of the franchisor's name mark (and other marks) may also need to be disclosed as one of the risk factors on the state cover page. The above cited FDD disclosure was identified as approved wording for this risk factor, which would be required to be stated in capital letters on the state cover page.

As a result of these requirements, a franchisor not yet having registration of its brand name may want to consider avoiding doing business in the registration states until the registration is secured. This could mean not making offers or sales (a) in the state, (b) to a resident of the state, or (c) for a franchise to be operated in the state.

As the owner of a registered or unregistered trademark, a franchisor has the right to change its mark for any reason at any time. Standard in most franchise agreements is the requirement that the franchisee change its signage and other mark-bearing materials if the franchisor changes its mark. It is also common for franchise agreements to require that the franchisee bear the cost of replacing all mark-bearing items. In the absence of registration, this should raise a red flag to both franchisee and franchisor counsel; franchisor counsel is obligated to inform the franchisor of the potential difficulty of selling franchises without the assurance of being able to use the brand name and of the likelihood of having to negotiate around this obstacle.

Franchisee counsel needs to advise the prospective franchisee that there is no guarantee to continued use of the franchise brand name and seek to amend the franchise agreement by adding provisions similar to the following:

- If Franchisor's mark changes because of the inability to secure registration on the Principal Register of the United States Patent and Trademark Office, Franchisor will reimburse Franchisee for the full amount of replacing signage, stationary, marketing materials and any other items comprised of or bearing Franchisor's mark. Franchisee reserves the right to provide Franchisor with good faith estimates of the cost of required replacements and will not be required to commence such changes until Franchisor has paid or placed in escrow an amount equal to the good faith estimates.

- Franchisor warrants that it owns its marks and agrees to indemnify Franchisee from any losses or damages resulting from any third party trademark infringement action.

- If Franchisor loses the right to lawfully use its name brand mark, Franchisee will have sixty (60) days following notice of the loss of the right to use the mark in which to notify Franchisor of Franchisee's intent to terminate the Franchise Agreement. Franchisee will be able to continue operating a [the type of] business in its location and/or territory under a name not confusingly similar to Franchisor's current or new name without violating any non-competition covenant contained in this Agreement.

The franchisor will likely object to the addition of any of the above provisions. In such a circumstance, the franchisee must decide if it is willing to assume the risk associated with becoming a franchisee of a system where the trademark is not federally protected.

Loss of the Trademark

When a franchisor fails to secure or loses the registration of its name, this can be fatal to the franchise system. Yet, case law addressing the failure to secure trademark rights or loss of trademark registration in the franchise context is sparse.

In a 40-year old case, a court held that there was a complete failure of consideration to the franchisee and awarded damages to the franchisee following termination of the franchise agreement. In *A to Z Rental, Inc. v. Wilson*, 413F.2d 899, (10th Cir. 1969), the Wilsons were granted a franchise but, before opening, both A to Z, the franchisor, and the Wilsons learned of a senior user of a similarly named business operating in the territory. A to Z encouraged the Wilsons to temporarily open under another name with the express understanding that A to Z would favorably and timely resolve the name issue with the senior user. A to Z failed to resolve the name issue and the Wilsons were forced to close their business. Later, but before bringing suit for breach of the franchise agreement due to the business closing, A to Z reached a partial agreement with the senior user. The court opined that the loss of the franchisor's exclusive right to use its trademark, together with other breaches of the franchise agreement, constituted a material breach of the franchise agreement. The court awarded damages to the Wilsons.

Two later cases resulted in denials of motions for summary judgment brought by multiple franchisees on the issue of whether the loss of a franchisor's name constituted a material breach of the franchise agreements. In each case, the courts stated that there was a question of fact whether loss of the brand name mark rose to the level of a material breach of the franchise agreement.

In *Multistate Transmissions, Inc. v. Cooney*, Bus. Franchise Guide (CCH) ¶ 9556 (E.D. Mich. January 11, 1990), Interstate Transmissions, the franchisor, after a lengthy court battle, lost the right to use its name in a case filed by Interstate Batteries. Interstate Transmissions filed for bankruptcy and then changed its name to Multistate Transmissions. Many franchisees experienced substantial decreases in sales allegedly due to the loss of the brand name. These franchisees opposed the efforts of the franchisor to assume their franchise agreements under 11 U.S.C. § 365. The court distinguished the circumstances before it from *A to Z Rental* because the franchisees received substantial training, marketing, and technical assistance from the franchisor. Thus, the loss of the right to use the name was not a per se violation of the franchise agreement as a matter of law.

In another 1990 decision, *In re Convenient Food Mart, Inc.,* Bus. Franchise Guide (CCH) ¶ 9599 (N.D. Ill. April 9, 1990), Convenient Food Mart, the franchisor, lost the registration of its mark due to the trade name being deemed to be generic. Convenient Food Mart owned at least four other registered trademarks and had protectable trade dress. The business value of the remaining trademarks and trade dress formed the basis for the denial of summary judgment. Convenient Food Mart, unlike Interstate Transmissions, was not required to change its name; however, it could not prevent others from using the same or a similar name. The court denied summary judgment brought by the franchisees on the basis of breach of contact and commercial frustration.

A franchisor can also lose its registration by failing to follow PTO renewal requirements. For example, Speedee Oil Change Systems, Inc., failed to timely renew its SPEEDEE trademark registration. Speedee sold franchises in California with UFOCs that failed to disclose this important loss of its trademark registration. The California Department of Corporations brought an action against Speedee and its sub-franchisors for, among many other things, misrepresentation and violation of the California Franchise Investment Law resulting from the lapsed registration. The court stated that "[i]t is of singular importance to prospective franchisees that they be able to rely on the unimpeded use of the marks and logos." *People v. Speedee Oil Change Systems, Inc.*, Bus. Franchise Guide (CCH) ¶ 11,548 (Cal. Supr. Ct., March 4, 1997). Perhaps more important was the following statement from this decision: "[t]he fact that no franchisee suffered detriment because of the lapsed registration does not render the failure to disclose immaterial." *Id.*

The failure to secure registration or loss of trade name registration can be fatal to the franchisor. For example, not too surprisingly, both Multistate Transmissions and Convenient Food Mart went into bankruptcy. As a result, *A To Z Rentals, Multistate Transmissions*, and *Convenient Food Mart* together suggest that a franchisor should have multiple registrations (preferably including or solely design elements); have substantial franchisee interaction beyond initial training and providing operations and other manuals; and confirm with reasonable certainty the right to use its marks, and trade name in particular, in a prospective franchisee's territory. *Speedee* suggests that a trademark registrant must actively monitor its registration(s) and that the franchisor must communicate with both trademark and franchise counsel.

A business new to franchising and without federal registration of its trade name should anticipate having difficulty selling franchises and having to make unwanted concessions. These concerns could be cause for identifying potential claims in response to the annual audit letter from a franchisor's auditor.

Franchisor counsel should encourage the business owner contemplating franchising to immediately seek federal registration of its trade name. or change that name and seek registration under a non-confusing name. Counsel should also make sure that trademark renewal requirements are being monitored.

Franchisee counsel should confirm in writing that a prospective franchisee understands that the franchise is at peril without federal trademark protection of the franchsisor's trade name and seek protections should registration not be successful.

For both sides of the franchise relationship, it is indeed, all about the trademark.

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