Counseling Licensors on the Steps They Can Take to Avoid Creating a Franchise Relationship[1]

by Michael F. Schaff and Lisa Gora

Tracy Mark, who has registered her company's brand name as a mark[2] with the U.S. Patent and Trademark Office, is successfully promoting her company's products and services and now would like to leverage the market appeal of her company's mark. Counsel advises that she can leverage the mark's market appeal by allowing others to use her company's mark. Counsel should further advise that she can allow others to use her company's mark by either: 1) creating a franchise relationship; or 2) creating a licensor-licensee relationship.

In discussing option one, counsel should have Mark take note that the creation of a franchise relationship, or even the appearance of a franchisor-franchisee relationship, would thrust her company into a strictly regulated environment that requires complex regulatory compliance, and potentially costly fines and penalties for noncompliance. In discussing option two and avoiding the franchise tag, counsel should have Mark take note that creating a licensor-licensee relationship benefits her company, the licensor, as well as the licensee, without thrusting her company into a highly regulated environment. However, in order to avoid the highly regulated environment, Mark, as licensor, must understand that she needs to proceed cautiously to avoid inadvertently creating a franchise relationship or the impression in the minds of consumers that there is a connection between her company, the licensor, and the licensee where her company could be seen by the public as 'vouching' for the activity of the licensee. Therefore, as part of the advice to Mark, counsel should stress the importance of licensors, like Mark, to understand what actions can unintentionally create a franchisor-franchisee relationship and thrust licensors under the guise of the New Jersey Franchise Practices Act (FPA).[3]

In New Jersey, a franchise relationship is created when the following elements are present:

1. a written agreement;
2. for a definite or indefinite period;
3. in which a person grants to another person a license to use a trade name, trade mark, service mark, or related characteristics; and
4. in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise.

A hallmark of the franchise relationship is the use of another's trade name in a way that creates a reasonable belief on the part of the consuming public that there is a connection between the trade name licensor and licensee, by which the licensor 'vouches' for the activity of the licensee in respect of the subject of the trade name.[4] In other words, if the licensee or the licensor holds itself out to the public or represents to the public that some special relationship exists between the two entities because of the control the licensor has over the licensee, a franchise relationship may be found to exist.

The courts have considered various factors when determining whether a franchise relationship has been created, such as:

1. whether there is a marketing plan or system prescribed in substantial part by the licensor onto the licensee;
2. the control by the licensor over the hours and days of operation of the licensor;
3. the control by the licensor over lighting, uniforms, prices, hiring, imposition of sales quotas, and management training of the licensee;
4. whether the licensor obligates the licensee to follow its site selection requirements;
5. the control the licensor has over production techniques and/or accounting operations of the licensee; and
6. the provision by the licensor of detailed operating manuals for the licensee to follow.

One of these elements alone does not necessarily create a franchise relationship; however, a combination of two or more may be enough to create a franchisor-franchisee relationship. If licensors are cognizant of these factors, then exposure to the penalties and strictly regulated environment of a franchise relationship may be avoided.

It is important to note that there is no precise formula that creates a franchise relationship, and in many states the statutory definition of franchise has been, and could be construed broadly to include, relationships between licensors and licensee even though neither party intended to create a franchise relationship. The following case law should be considered as a measure of how the courts in various jurisdictions have interpreted certain factors when determining whether the relationship between two entities was such that a franchise relationship was created.

In *Instructional Sys. Inc. v. Comp. Curriculum Corp.,*[5] the New Jersey Supreme Court found a franchise relationship existed between a distributor and producer because, although the distributor at all times operated under its own name and did not adhere to structural or procedural schemes of the producer and never paid a license fee to the producer, the relationship between the distributor and producer created an appearance to the consuming public that the two entities were related. The distributor had the right to use the producer's name, trademark and logo in its advertising, at exhibits and at trade shows, and had the duty to use its best efforts to promote the producer's products. Based on these characteristics, the Court determined that a franchise relationship existed.

In *Ross v. Shell Oil Co.,*[6] the United States District Court for the District of Connecticut found a franchise relationship did not exist between a lessee and a lessor because there was insufficient control by the lessor over the lessee. Although the lease prepared by the lessor contained provisions that, among other things, required the lessee to operate during certain hours, based the lessee's rent upon the volume of business, and required the lessee to obtain the lessor's approval regarding the use of signs for advertising on the premises, the court found those factors alone were insufficient to create a franchise relationship.

On the other hand, in *Hartford Elec. Supply Co. v. Allen-Bradley Co., Inc.,*[7] the Connecticut Supreme Court found a franchise relationship was created because a great level of control was exerted over the distributor by the manufacturer in many aspects of the distributor's business. More specifically, the distributor's business plan was subject to the manufacturer's approval; the manufacturer possessed power over the distributor's pricing; the manufacturer possessed some control over the distributor's personnel choices; the manufacturer demanded extensive training of the distributor's personnel regarding the manufacturer's products; the manufacturer exerted significant control over the distributor's inventory; and, under the agreement between the distributor and manufacturer, the manufacturer had a right to examine the distributor's financial records and to require audits.

Additionally, in *RJM Sales & Marketing, Inc. v. Banfi Product Corp.,*[8] even though there was not a significant amount of control between the licensor and licensee as in other cases, the United States District Court for the District of Minnesota still found a franchise relationship was created where a licensor permitted a licensee to use the licensor's business name in audio-visual presentations, brochures, and printed materials (supplied by the licensor) in the licensee's advertising scheme.[9] The court noted that the grant of a right to use the franchisor's name was sufficient evidence to find a franchise relationship under these facts.

In any event, the courts will look at the totality of the circumstances when determining whether a franchise relationship exists. The fact that certain factors are deemed to create a franchise relationship in one situation does not necessarily mean that whenever those factors are present a franchise relationship will be found. For example, in *re Matterhorn Group, Inc.,*[10] the Bankruptcy Court of the Southern District of New York determined that a franchise relationship existed under the FPA where, among other factors, the licensee was required by the licensor to post signs and indicate in its advertising that it was simply an authorized licensee of the licensor and not acting on behalf of the licensor. The posting of such signs may, in other situations, minimize the appearance of a franchise relationship; however, under the totality of circumstances in this case, the court still found that there was enough control exerted over the licensee by the licensor to create a franchise relationship because of the following factors:

1. under the parties' licensing agreement the licensee could only sell the licensor's products and was to use its best efforts to do so;
2. the licensee was required to build its stores in accordance with the licensor's common design and store trade dress to look like the licensor's other stores or kiosks;
3. the licensee had to post signs and indicate in advertising that it was an authorized licensee of the licensor;
4. the licensee could only use advertising approved by the licensor;
5. the licensee had to uphold the licensor's public image;
6. the licensor required the licensee's personnel to be courteous and knowledgeable; and
7. the licensor required the licensee to provide warranty service.

Although it is not an exact science, and subject to court interpretation, there are some steps a licensor can take to avoid the creation of a franchise relationship.

- The licensor should not use language in the license/contract that requires the licensee to promote the licensor's products through advertising or exhibitions.
- The licensor should not use language in the license agreement/contract that requires the licensee to use its best efforts to promote the licensor's products.
- The licensor should not prohibit the licensee from selling competitive products.
- The licensor should not require the licensee to use certain parts, pieces or ingredients to make the licensee's products.
- The licensor should not use language restricting the licensee to use only the licensor's trademark or licensor's products.
- The licensor should not engage in

joint sales, marketing, promotional or maintenance activities with the licensee.

- The licensor should not supply the licensee with marketing or promotional materials or reimburse the licensee for such materials.
- The licensor should not refer to the licensee's office as a 'sales office' of the licensor or vice versa.
- The licensor should not permit the licensee to maintain signage with the licensor's address and the licensee's address under the same logo/name. The licensor should not maintain any signage using the licensee's address/name or logo alongside the licensor's name/address or logo in order to avoid the appearance of any agency relationship.
- The licensee should not advertise itself as an authorized or exclusive provider of the licensor's products.
- The licensor should not permit the licensee to use the licensor's marketing program.
- The licensor should not monitor the financial performance of the licensee.
- The licensor should not assist the licensee in obtaining inventory or equipment.
- The licensor should not control the time and manner of the licensee's performance, but may mandate the standards of performance (without controlling the means).
- The licensor should not prescribe a business operating system or operating manual to be followed by the licensee.
- The licensor should not retain control or have the right to control certain aspects of the licensee's business.
- The licensor should not mandate standards of performance, but instead should provide suggested and purely advisory standards and identify them as suggested and advisory.
- The licensor should not hire or fire the licensee's employees or have the right to hire or fire.
- The licensor should not supervise or assign work, set work schedules or establish working conditions of the licensee's employees.
- The licensor should not determine the rate and method of payment for the licensee's employees.
- The licensor should not maintain the employment records concerning the licensee's employees.
- The licensor should make clear in the licensor-licensee agreement that the intent of the relationship between the licensor and licensee is not one of a franchise relationship.

In summary, Mark, or other similarly situated clients, should be counseled to proceed with caution when engaging in business interactions with a licensee. It should also be stressed that they should minimize their control over licensees as much as possible to prevent the imposition of a franchise, in order to avoid entering a highly regulated environment fraught with complex regulatory compliance and potentially costly fines and penalties for noncompliance. ⚖

Endnotes

1. Please note that portions of this article were taken from a similar article published in the *Business Law Section Newsletter* of the New Jersey State Bar Association written by Anthony Wilkinson and Lisa Gora.
2. For the purposes of this article, a 'mark' shall mean a trademark for use in marketing goods or a service mark for use in marketing services.
3. N.J.S.A. §§ 56:10-1 to 56:10-15.
4. *Neptune T.V. & Appliance Service, Inc., V. Litton Microwave Cooking Products Division, Litton Systems, Inc.*, 190 N.J. Super. 153 (1983).
5. 130 N.J. 324, 614 A.2d 124 (1992).
6. 672 F. Supp. 63 (D. Conn. 1987).
7. 250 Conn. 334, 736 A.2d 824 (1999).
8. 546 F. Supp. 1368 (D. Minn. 1982).
9. *Id.* at 1373 (*quoting Martin Investors, Inc. v. Vander Bie*, 269 N.W.2d 868, 874 (Minn. 1978)).
10. 2002 WL 31528396 (Bankr. S.D. N.Y. 2002).

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