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LICENSING A TRADEMARK? BEWARE OF THE FRANCHISE LAWS

by
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Is your client's business licensing the right to use its trademark (or service mark) to other entities, either by agreeing to let other entities use the mark or by giving other entities the right to sell goods bearing the mark? If so, your client's business may be subject to the franchise laws which are implemented by the Federal Trade Commission (FTC) or which are in effect in about one-third of the states, including California. A failure to comply with the franchise laws could result in the licensor's liability for damages, penalties, attorney's fees, rescission, and administrative stop orders. Joint and several liability of corporate officers, directors, and employees of the corporate licensor is also possible. It therefore behooves an attorney to consider the franchise laws when drafting a trademark license.

Under both federal and state law, a trademark owner/licensor must exercise proper quality control of the use of the trademark by licensees or face the potential loss of all its legal rights in the mark. On the other hand, exercising too much control can subject a licensor to the extensive and highly technical disclosure requirements, as well as other obligations, under the franchise laws. This dilemma raises the question whether a trademark licensor can preserve its trademark rights and yet be free from obligations under the franchise laws? The answer to this question is unclear, as the following discussion of current trademark and franchise law indicates.

NECESSARY QUALITY CONTROL NECESSARY TO RETAIN RIGHTS IN A LICENSED TRADEMARK

In order to protect its rights in a trademark, a trademark licensor must control the licensee's use of the mark to maintain the quality of products and/or services sold under the mark. See, e.g., *Transgo Inc. v. Ajac Transmission Parts Corp.*, 768 F.2d 1001 (9th Cir. 1985); see also 15 U.S.C. Sections 1055 and 1127. While it is well settled that quality control is required for a licensor to maintain rights in a trademark, the courts have not clearly defined the minimal quality control required.

A license without any right to control in the licensor, coupled with the absence of any actual control of the licensee's use of the mark, results in an abandonment of the licensor's rights in the mark. See, e.g., *General Motors Corp. v. Gibson Chemical & Oil Corp.*, 786 F.2d 105 (2nd Cir. 1986); *Dawn Donut Co. v. Hart's Food Stores Inc.*, 267 F.2d 358 (2nd Cir. 1959); *Nat'l Trailways Bus System v. Trailway Van Lines, Inc.*, 269 F. Supp. 352 (E.D. N.Y. 1965). However, the amount of quality control required to maintain rights in a licensed trademark depends upon the circumstances surrounding the license. Factors affecting the degree of control necessary to preserve rights in a trademark include the nature of the products and services sold under the licensed mark, the kinds of quality control that are used, the expertise and past record of the licensee in marketing the kinds of goods or services to be sold under the mark, and the sophistication of the consumers of the marked goods or services. As a result, the minimal measures required to protect trademark rights varies from one licensee to another. In addition, the courts have not defined what constitutes minimal quality control to preserve rights in a licensed trademark.

DISCLOSURE OBLIGATIONS UNDER THE FRANCHISE LAWS

Franchises are regulated at the federal and, in some jurisdictions, at the state level. The FTC has established minimum standards for franchises, including a requirement that all franchisors give each potential franchisee a copy of the franchise agreement and an offering prospectus prior to the execution of a contract or the payment of consideration regarding the franchise. See 16 C.F.R. Sections 436.1(a), (g) and 436.2(g), (o). The offering prospectus generally must disclose specified information regarding the background of the franchisor, the cost of

the franchise, termination and renewal of the franchise, and any restrictions in the franchise agreement. See 16 C.F.R. Sections 436.1 and 436.2(n).

State franchise laws have disclosure requirements similar to those of the FTC, with the additional requirement that the franchisor register with the state. State laws which provide equal or greater protection to prospective franchisees than the FTC regulations, whether or not the state laws are in conflict with those regulations, are not preempted. See 16 C.F.R. Section 436.3, n.2.

DEFINITION OF FRANCHISE UNDER THE FRANCHISE LAWS

Whether a trademark licensor can avoid incurring disclosure obligations under the franchise laws usually depends on whether the trademark license and any related agreements constitute a "franchise" under state or federal law. Generally, a trademark license is much more likely to be regarded as a franchise under state law than under federal law. The FTC's definition of franchise is generally limited to those arrangements which are more typically thought of as franchises. On the other hand, state law definitions of franchise laws have been interpreted broadly by state agencies and court decisions.

Federal Definition of Franchise

The definition of franchise under the FTC's regulations includes two general kinds of arrangements. First, a franchise generally exists when (i) the franchisee pays the franchisor for (ii) the right to sell goods or services under the franchisor's trademark and (iii) the franchisor exerts a "significant degree of control" over or gives "significant assistance" to the franchisee's "method of operation." 16 C.F.R. Section 436.2(a)(1)(i). This first kind of franchise is characterized by the FTC as "package and product franchises," such as fast food outlets. See 16 C.F.R. Part 436(1)(A).

The second kind of arrangement which may be deemed a franchise under FTC regulations applies primarily to distributorships where the franchisor secures customers or retail outlets for the franchisee. See 16 C.F.R. Section 436.2(a)(1)(ii). This kind of arrangement is not as likely to affect typical trademark licenses as the first kind of franchise. A consideration of such arrangements is beyond the scope of this article.

The "package and product" type of franchise discussed above may impact a prospective trademark licensor. A trademark license almost always requires the licensee to pay a fee for the right to sell goods or services under the licensor's mark, thus meeting the first two requirements for a franchise under FTC regulations. Therefore, the question whether a franchise is created would ordinarily turn on meeting the third requirement, i.e., whether the control by or assistance of the franchisor is "significant." Although this standard gives the FTC much latitude, the FTC has chosen to construe it narrowly. For example, the FTC regulations expressly state that assistance with the franchisee's promotional activities alone is not enough to constitute "significant" assistance. 16 C.F.R. Section 436.2(a)(1)(i)(B)(2).

The narrow scope given to the definition of franchise by the FTC probably means that a trademark license with minimal quality control standards would not be subject to the federal franchise laws. For example, if the only control of the licensor is a clause in the license by which the licensee promises to maintain specified quality standards, coupled with subsequent monitoring by the licensor of the licensee's products or services which have reached the market, the license probably does not fall within the FTC's definition of franchise. However, it should be noted that the FTC standard is very flexible. Therefore, if the franchisor controls or assists the franchisee's business operation in any significant way, the license could be deemed a franchise.

State Definitions of Franchise

The state law definitions of franchise are broader than the federal definition. There are two general types of state franchise statutes presently in effect.

State Majority View

In a majority of those states with franchise laws, including California, a franchise generally exists when

an agreement (i) requires the franchisee to pay a franchise fee, (ii) gives the franchisee the right to operate its business in association with the franchisor's trademark, and (iii) allows the franchisee to sell goods or services under a "marketing plan or system" substantially "prescribed" by the franchisor. See, e.g., Cal. Corp. Code Section 31005. As under the FTC regulations, a trademark license usually meets the first two requirements, unless the license is a bona fide wholesale distribution agreement. (The mere sale of goods at a bona fide wholesale price is not deemed to involve a franchise fee in most states.) Thus, the key question is usually whether the sales are under a "marketing plan or system" substantially "prescribed" by the franchisor.

At first blush it may appear that the term, "marketing system or plan," would limit the franchise laws to those arrangements typically considered to be franchises, such as fast food outlets. However, this element of the definition of a franchise has generally been interpreted broadly by the state agencies implementing the franchise laws.

Several factors are considered by state agencies in determining whether a relationship between a trademark licensee and licensor involves a "marketing plan or system." Among the factors ordinarily considered are whether the franchisee is required (i) to purchase the marked goods from designated or approved suppliers, (ii) to follow operating plans or procedures or training manuals specified by the franchisor, (iii) to limit the type, quantity, or quality of goods or services sold, and/or (iv) to limit sales to certain customers. Other factors include whether the franchisor (v) is able to terminate the agreement at will and/or (vi) assists the franchisee with training, marketing, or sales locations.

For a trademark license to constitute a "marketing system or plan," not all of the above factors have to be present. Moreover, it is possible that a state agency would consider a trademark license which meets one of those factors to be a marketing plan or system. As discussed above, trademark licensors are required to control the quality of products sold under the license. Therefore, a trademark license will ordinarily meet factor (iii) above. Moreover, trademark license agreements often require that franchisees purchase goods from the franchisor or from specified or approved sources, thus meeting factor (i) above. Other elements frequently found in trademark licenses, such as a requirement to follow specified quality control procedures, meet other factors listed above. In conclusion, trademark licenses which have sufficient quality control measures to protect rights in the mark could be construed by state agencies to involve a "marketing system or plan."

The remaining question to consider is whether the marketing system is "prescribed" by the franchisor. This requirement usually has a very low threshold. In many states it is construed to include a mere suggestion of a marketing system by the franchisor.

Therefore, it is possible that even a trademark license with minimal quality control measures would be deemed a franchise in many states with majority-view franchise laws. As a result, most trademark licenses, not including bona fide wholesale distribution arrangements, could invoke the disclosure obligations of the franchise laws in many states.

State Minority View

In a minority of states with franchise laws, the first two requirements to establish the existence of a franchise are substantially the same as under the majority view. That is, a franchise fee and association with a trademark or service mark are required. Moreover, wholesale distribution arrangements, whereby the franchisee purchases goods at a bona fide wholesale price, are generally excluded from the definition of franchise under the minority view, as under the majority view. However, the "marketing plan or system" requirement is replaced by the requirement that the franchisor have a "community interest" with the franchisee, in a minority of states.

The "community interest" standard is generally broader than the "marketing plan or system" standard. The "community interest" standard usually means the franchisor has a continuing financial interest in the operations of the franchisee. Therefore, a trademark license under which the franchisee sells goods or services purchased from the franchisor usually establishes a franchise relationship (unless, of course, the license is a bona fide wholesale distribution arrangement). A continuing financial interest is established in the foregoing type of license because the licensor's earnings are at least partly dependent upon the licensee's sales of the goods or services. Also, a trademark license in which the licensor receives royalties based upon the sales levels of the licensee would generally yield the same result. Furthermore, license provisions allowing the licensor to terminate the license if specified sales or profit levels are not

reached may constitute a continuing financial interest. The "community interest" standard is thus very broad and probably includes most trademark licenses in effect today.

CONCLUSION

In summary, a trademark license with minimal quality control measures is not likely to give rise to obligations under the FTC's franchise regulations. However, any measures taken beyond the required minimum could invoke the federal franchise laws. This situation is troublesome for the trademark owner because the courts have not clearly defined what constitutes the "minimal" quality control required to maintain rights in a licensed trademark.

In those states with franchise laws, even the trademark license with only minimal controls could invoke franchise disclosure requirements. In fact, trademark licenses coupled with sales of goods or services by the franchisor, which are not pure wholesale distribution agreements, probably give rise to obligations under many state franchise laws. Therefore, whether a trademark licensor can retain legal rights in the licensed mark and still avoid obligations under the franchise laws remains unclear.

As discussed above, the remedies which can be obtained against a franchisor for failure to comply with the franchise laws are potentially severe. Therefore, an attorney should always consider the applicability of the franchise laws in drafting a trademark license.

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