Intersection of Trademark and Franchise Law

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In this article, Daniel Shulman and Joshua Grant, intellectual property attorneys at Vedder Price P.C., discuss the intersection of trademark law and franchise law. We examine the statutory underpinnings of franchise law and, in the process, identify how and why franchise law necessarily intersects with the trademark law. We compare ordinary trademark-license law, which is neutral as between licensors and licensees, with franchise law, which is intentionally pro-franchisee. With that perspective in mind, we identify a trademark license as an essential feature of a franchise arrangement, and therefore any trademark license that is not written with franchise rules in mind may create specific and material risks for a trademark licensor. We identify how a trademark-license arrangement may inadvertently create a franchise agreements. We further identify some potentially catastrophic results for the licensor, such as the inability to terminate a license and a requirement to pay damages resulting from the termination of a trademark license. We recommend certain states and state statutory schemes that create different risks, and we recommend extra caution when creating trademark license in those states. We explain why licensors must consider state and federal franchise laws before entering into a trademark-license agreement with a prospective licensee.

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I. INTRODUCTION

In this article, we discuss the possibility that trademark licensors will unintentionally become entangled in a franchise agreement. Trademark licenses are a key component of franchise agreements. If the licensor fails to understand the elements of a franchise agreement, they may inadvertently subject themselves to the rules governing a franchise, which provide substantial rights to licensees and may impede the right of the licensor to terminate the agreement without liability or substantial legal fees. This article will allow readers to gain a better understanding of trademark law as well as trademark licensing. With this information, readers will be better able to protect the value of trademarks and trademark licenses without accidentally entering into a franchise agreement.

Consider the following hypothetical. Company A owns a well-known trademark for X goods. Company B wishes to use this mark in association with its own Y goods to benefit from Company A's name recognition. Company A poured significant resources into developing a brand around the trademark and is willing to license the mark to Company B for a fee so long as Company B adheres to the standards of Company A's X goods. Company A wants to maintain its trademark's reputation for excellence and is worried that substandard goods will hurt the value of the trademark. Therefore, Company A includes several restrictions and limitations on Company B's use of the trademark.

Soon, the companies execute an agreement stating that if Company B fails to meet any of the standards or limitations included in the agreement, Company A may cancel the license. A few months later, Company A discovers that Company B is not living up to the requirements of the agreement and notifies Company B that the license has been terminated.

Soon thereafter, Company B files suit against Company A for violation of state and federal franchise laws. Company B alleges the parties had a franchise relationship and that Company A violated franchise-relationship laws by terminating the franchise without proper notice. Company A is now possibly liable to Company B for Company B's own failures to follow its license agreement.

The result is not at all what Company A intended. It probably did not even consider such a result when it decided to license its trademarks. So, how did Company A get there? It failed to understand and adapt to the intersection of trademark law and franchise law. This article will explain what Company A *should have known* before it licensed its trademark to Company B.

Part I of this article will briefly cover the concept of trademarks as well as trademark licensing. Part II of the article will explore franchise law nationally and state by state. Part III will explore how trademark and franchise law intersect. Finally, Part IV of this article will make recommendations on how to protect the value of trademarks and licenses without accidentally entering into franchise agreements.

II. WHAT'S THE PROBLEM?

A trademark license agreement is, all other things being equal, an ordinary contract governed by ordinary contract principles. Parties can contract around termination provisions so that either party (including the licensor) can terminate at will, or with whatever notice the parties agree to. The parties remain independent, arm's-length companies. And, certainly, breach of a garden-variety trademark license, like any ordinary breach of contract, is a purely civil matter without any possibility of criminal penalties.

Franchise agreements, however, fall under different legal and regulatory schemes. As demonstrated below, a characteristic of a franchise relationship is that the franchisee is substantially dependent on the franchisor, and therefore has a diminished bargaining position.[1] A trademark license that—even inadvertently—gives rise to a franchise relationship

1. Thueson v. U-Haul Int'l, Inc., 50 Cal. Rptr. 3d 669, 673 (Cal. Ct. App. 2006) ("[T]he purpose of most franchise laws is to protect franchisees who have unequal bargaining power . . . ." (citing Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128, 135 (7th Cir. 1990))).

can have serious consequences for the licensor. Among other things, a franchisor may be subject to the following:

- Registration and disclosure requirements as a franchisor;[2]
- Prohibitions against certain forms of termination, or lengthy notice provisions;[3]
- Requirements to reimburse the franchisee for early termination;[4]
- Strict requirements concerning renewal of franchise agreements with lengthy advance-notice requirements;[5]
- Penalties for failure to comply with certain state requirements;[6]
- Vicarious liability (e.g., workers' compensation) for actions of the franchisee;[7] and
- Additional franchise taxes on payments from the franchisee.[8]

These things are typical in a franchise relationship, but almost none is an intended (or desired) consequence of a trademark license, at least for the licensor.

III. TRADEMARKS AND TRADEMARK LICENSING

A trademark is a symbol most often used by a company to identify the source of the product or services the company offers.[9] As consumers come to associate the trademark with a particular company, the trademark adds value to the company.[10] This added value opens the door to licensing agreements or other transactions to increase the value of the company.

A. Trademarks Protect and Signify Consumer Goodwill

There are many principles behind trademark law; however, in general,

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2. *See infra* Section IV.B.
3. *Id.*
4. *See infra* Section IV.C.
5. *Id.*
6. *Id.*
7. *See* Doctor's Assocs., Inc. v. Uninsured Emp'rs' Fund, 364 S.W.3d 88, 93–94 (Ky. 2011) (reversing lower court's decision that franchisor was not liable to provide workers' compensation to franchisee).
8. *See* A&W Rests., Inc. v. Taxation & Revenue Dep't, 429 P.3d 976, 981 (N.M. Ct. App. 2018) (concluding that taxable gross receipts include royalties received from a franchise agreement, thus increasing taxes imposed on franchisor).
9. *Trademarks*, WORLD INTELL. PROP. ORG., https://www.wipo.int/trademarks/en/ [https://perma.cc/9YED-RFZW] (last visited Aug. 29, 2021) ("A trademark is a sign capable of distinguishing the goods or services of one enterprise from those by other enterprises.").
10. Oskar Duberg, *7 Major Benefits of a Strong Brand*, FRONTIFY, https://www.frontify.com/en/blog/7-major-benefits-of-a-strong-brand [https://perma.cc/9ML8-5MH7] (last visited July 5, 2021). This value may come in the form of brand recognition, customer loyalty, and stronger effectiveness in advertising. *Id.*

"[t]rademark law serves to protect consumers from deception and confusion over trademarks as well as to protect the plaintiff's infringed trademark as property."[11] Trademarks are considered symbols of goodwill.[12] A trademark's existence is entirely dependent on the goodwill earned from the use of the trademark in connection with the goods or services.[13]

Goodwill plays an integral role in the buying habits of consumers, because consumers will tend to return to products and services they have found acceptable.[14] These positive interactions build goodwill towards businesses and form buying habits.[15] Therefore, trademarks provide businesses with a symbol with which consumers associate their goodwill.

Additionally, consumers may come to associate a trademark with a particular level of quality.[16] This may enhance the brand of the company associated with the mark and add value to the business. For instance, when one firm buys another, it not only purchases the actual value of the firm, it also purchases the firm's goodwill and reputation. A business may often value the goodwill of its company at ten percent of its total assets.[17]

Companies can license their marks to gain value from the goodwill and reputation they have developed with consumers. Though, these companies must be careful to maintain the goodwill of their marks.

B. Licensing a Trademark

Because a trademark is capable of indicating both the source of the goods as well as their quality, a trademark owner—the licensor—must attempt to maintain the quality of the goods or services provided in connection with the mark.[18] Without the proper quality controls, a trademark may lose the goodwill associated with the mark and result in a decrease in the value of the mark, or even loss of rights to the mark itself.[19]

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11. J. THOMAS MCCARTHY, 3 MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 2:2 (5th ed. 2021).
12. *Id.* § 2:15.
13. *Id.*
14. *See generally id.* § 2:18.
15. *Id.*
16. *See* Monique L. Ribando & Michael S. Pavento, *Quality Control in Trademark Licensing*, CORP. COUNS. BUS. J. (Aug. 1, 2007), https://ccbjournal.com/articles/quality-control-trademark-licensing [https://perma.cc/978S-CNZ3] (discussing importance of trademark licensing for quality-control purposes).
17. *See* MCCARTHY, *supra* note 11, § 2:19 ("Goodwill and other intangibles on the books of companies in the S&P 500 are valued at $2.6 trillion or 10% of their total assets, according to the analysts at Goldman Sachs.").
18. *Id.* § 18:40.
19. Courts have stripped trademark owners of their rights when they engage in "naked licensing," i.e., licensing of a trademark without the appropriate quality controls. *See* FreecycleSunnyvale

Therefore, when companies choose to license their trademarks, they will often implement quality control in order to maintain the quality of the goods sold under the trademark.[20] This is to protect against devaluation of the trademark.[21] For instance, if consumers had come to associate a trademark with high-quality work, the trademark would lose value if suddenly a licensee began using the trademark on low-quality goods. Consumers may find the change off-putting and come to associate the mark with lesser-quality goods.[22] The resulting decrease in goodwill may lead to decreases in the number of consumers who purchase goods under the mark and thus decrease its value.

In fact, it is a matter of settled trademark law that a trademark license that does not include provisions for quality control (sometimes referred to as a "naked trademark license") will constitute abandonment of the licensor's trademark.[23] The rationale is straightforward—if the licensor cares so little about the quality of the goods and services being offered under its trademark, then it has no regard for its goodwill. Without goodwill, a trademark has no independent meaning, so a licensor who abandons its goodwill abandons its trademark.[24]

Therefore, a trademark license agreement will typically include quality control provisions to ensure that any products or services offered under the licensed trademark meet the same quality threshold as the existing products or services offered in connection with the mark.[25]

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v. Freecycle Network, 626 F.3d 509, 515 (9th Cir. 2010) (determining that organization abandoned the trademarks due to its engagement in naked licensing).

20. *See* Ribando & Pavento, *supra* note 16 ("Quality control provisions are foundational in any trademark license agreement. Quality controls protect the trademark owner's reputation by specifying certain minimum quality standards must be met by the licensee.").

21. *See id.* ("[T]he licensing arrangement must be designed to maintain the value and integrity of the trademark . . . ."). Additonally, it protects rights to the trademark itself. *See id.* ("If a licensor does not exercise sufficient control . . . the trademark may . . . be deemed abandoned . . . .").

22. *See* MCCARTHY, *supra* note 11, § 3:11 ("Since consumers will be confused as to source, they will attribute quality deficiencies in the infringer's goods or services to the legitimate owner of the mark.").

23. *See, e.g.*, Barcamerica Int'l USA Trust v. Tyfield Imps., Inc., 289 F.3d 589, 598 (9th Cir. 2002) ("[I]t is well established that where a trademark owner engages in naked licensing, without any control over the quality of goods produced by the licensee, such a practice is inherently deceptive and constitutes abandonment of any rights to the trademark by the licensor." (citations omitted)).

24. *See* EH Yacht, LLC v. Egg Harbor, LLC, 84 F. Supp. 2d 556, 570 (D.N.J. 2000) ("[I]f the good will built up by the mark has so declined that the mark is 'no longer associated with the business, in the public mind, then the mark should be regarded as abandoned . . . .'" (citing MCCARTHY, *supra* note 11, § 17.13)).

25. Ribando & Pavento, *supra* note 16.

C. Quality Control of a Trademark

The necessity of quality control means that every trademark license involves some amount of interconnectedness between a licensor's and licensee's business on an ongoing basis. Quality-control provisions may include strict guidelines that restrict the use of the licensed trademark. These guidelines are not only limited to product or service specifications; they may require product inspection procedures, the right of the licensor to routinely inspect production, and guidelines on where to affix the mark.[26]

The more control exerted by the licensor, the more likely the licensor is to maintain the goodwill of the mark. But while licensors may want to maximize control over the trademark, more control comes with the risk of forming a franchise with the licensee. Franchise law may expose the licensor to varying degrees of liability depending on the state where the franchise is formed.

IV. FRANCHISE LAW

A franchise can be thought of as an independent business that is run as a brand extension of a specific business owner. For example, a person may open and run a very successful quick-serve restaurant—let's call it "Burger Queen"—in her neighborhood. After years of success and goodwill around the brand, the food, and perhaps even the look and feel of the restaurant, the owner of Burger Queen may feel like she can expand to other locations. If she has the time, capital, and patience, she can build her own locations, one by one, and try to run all of them herself. Or, she can create a "franchise" by allowing other people to run privately owned restaurants that look, feel, and operate like her original Burger Queen. She will not own those restaurants, but because she licenses her intellectual property to those independent restaurant owners, the consumers will not know the difference. Every Burger Queen, from Brooklyn to Bangkok, should feel, look, and taste the same. As one might imagine, the franchise owner and the franchisees are in a very interdependent relationship. The franchisee needs the franchise owner's intellectual property, whereas the franchise owner needs the franchisee to operate their business in a certain way. Franchise law ensures balance in that relationship.

A. Why Does It Exist?

In a traditional franchisor-franchisee relationship, the franchisee is

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26. *Id.*

highly dependent on the franchisor.[27] Imagine opening a McDonald's restaurant as a franchisee. Because the McDonald's experience must be the same across all McDonald's (i.e., strict and onerous quality control), your investment is tailored to what McDonald's asks you to do: from how you cook the food, to how you package it, to the type of seating you use, to the menu, to the shape of the garbage cans.[28] Virtually everything you do has some kind of McDonald's branding or goodwill (i.e., trademark) associated with it.

Now imagine, after you have made your investment, McDonald's decided to terminate your agreement. Because of the dependent and specific nature of your investment, most of it could not be repurposed, at least without significant expense. The scenario might be similar if you franchised a gas station to supply Mobil gasoline, and Mobil decided to terminate your agreement.[29] It would be expensive to switch over all the equipment, all the signage, and all the gas-delivery systems to a competitor.[30] To a significant degree, without some protections, a franchisee is at the mercy of a franchisor.

Because of the dependent nature of the franchisee-franchisor relationship, both state and federal governments have franchise laws and regulations to protect franchisees from bad behavior and misrepresentations of franchisors.

One example of the type of protection given to franchisees is the federal "Franchise Rule" promulgated by the U.S. Federal Trade Commission.[31]

> The Franchise Rule gives prospective purchasers of franchises the material information they need in order to weigh the risks and benefits of such an investment. The Rule requires franchisors to provide all potential franchisees with a disclosure

27. *See, e.g.*, Neptune T.V. & Appliance Serv., Inc. v. Litton Microwave Cooking Prods. Div., Litton Sys., Inc., 462 A.2d 595, 601 (N.J. Super. Ct. App. Div. 1983) ("[T]he franchisor is primarily interested in the volume of the franchisee's sales, not necessarily the franchisee's profitability . . . it matters little to [the franchisor] whether . . . a particular franchisee can continue in business . . . there will always be another franchisee available . . . .").

28. *See generally Amended and Restated Master Franchise Agreement for McDonald's Restaurants*, U.S. SEC. & EXCH. COMM'N ARCHIVES (Nov. 10, 2008), https://www.sec.gov/Archives/edgar/data/1508478/000119312511077213/dex101.htm [https://perma.cc/6UBU-FYBZ].

29. *See generally ExxonMobil Oil Corporation Brand Fee Agreement*, U.S. SEC. & EXCH. COMM'N ARCHIVES, https://www.sec.gov/Archives/edgar/data/1323468/000110465911002124/a11-4279_1ex10d6.htm [https://perma.cc/9UDR-AZZ4] (last visited Apr. 11, 2022).

30. In fact, Congress specifically passed the Petroleum Marketing Practices Act to protect gas-station franchisees. Petroleum Marketing Practices Act, 15 U.S.C. §§ 2801–2841 (1976).

31. *Franchise Rule*, FED. TRADE COMM'N, https://www.ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/franchise-rule [https://perma.cc/ZL3P-6M6R] (last visited Aug. 29, 2021).

> document containing 23 specific items of information about the offered franchise, its officers, and other franchisees.[32]

The so-called Franchise Disclosure Documents (FDDs) must contain information such as, among other things: business history and experience of the franchisor, including litigation information and bankruptcy information within the past ten years; financial factors such as fees and conditions for refund; and obligations of the franchisor and franchisee.[33] While these disclosures are merely meant to protect franchisees from bad-faith franchisors, the disclosures can be burdensome to franchisors. Additionally, as described below, the FDDs may be an integral part of specific states' regulatory schemes as well.[34]

B. Franchise Agreements

The law imposes certain obligations on franchisors. But, to be subject to those obligations, a franchisor must first enter into a franchise agreement with its franchisee.

This is where the situation can become troublesome for a trademark licensor. In many states, the elements of what constitutes a "franchise agreement" may look very similar to a "trademark license agreement." In those cases, the trademark licensor (such as in our example, Company A in the introduction) may inadvertently find itself a franchisor.

For instance, in *A&W Restaurants Inc. v. Taxation and Revenue Department*, the New Mexico Court of Appeals broadly described a franchise as "a license from the owner of a trademark . . . permitting another to sell a product . . . under that [trade]mark . . . ."[35] While the court went on to explain the specific elements of a franchise, the overlap between franchises and trademark licenses is quite clear.

In general, franchise agreements can be boiled down to three elements: (1) a license to a trademark, (2) a marketing plan, and (3) a franchise fee.[36] What each element entails may vary from jurisdiction to jurisdiction.

1. Federal Law and Federal Trade Commission Rules

Under federal law, a franchise is defined as including (1) a promise to provide a trademark or other symbol, (2) a "promise to exercise

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32. *Id.*
33. 16 C.F.R. § 436.5 (2011).
34. *See infra* Section IV.B.2.
35. A&W Restaurants, Inc. v. Tax'n & Revenue Dep't, 429 P.3d 976, 979 (N.M. Ct. App. 2018).
36. Rochelle B. Spandorf, *Expert Q&A on Trademark Licensing and Accidental Franchises*, INTELL. PROP. & TECH., Apr. 2016, at 16, 16.

significant control or provide significant assistance in the operation of the business," and (3) a minimum payment to the franchisor of at least $615 during the first six months of operations.[37] The self-identification of the arrangement is irrelevant (i.e., it doesn't matter what the parties call it).[38] The determinative issue is whether the three elements are met.[39] The rule applies whether the business arrangement is oral or in writing.[40]

The first element, the trademark license, is uncomplicated. The term "trademark" is intended to be read broadly. It covers trademarks, service marks, other advertisements, and commercial symbols.[41]

The second element, significant control, has a finer point that may rescue some trademark licenses. The control must relate to the franchisee's overall method of operation and not a small portion of the franchisee's business.[42] Examples of significant control include "site approval for unestablished businesses; site design or appearance requirements; hours of operation; production techniques; accounting practices; personnel policies; . . . restrictions on customers; and locale or area of operation [restrictions]."[43] Promotional activities do not rise to the level of "significant."[44] The effect of the "significant" limitation is to insulate a trademark licensor from creating a franchise arrangement where the trademark license is not a core element of the licensee's business. For example, a licensee that sells hundreds of products may not be able to establish a franchise agreement if the trademark license only applies to one of them and that one product is relatively small from an overall business standpoint. An example might include when a large chain restaurant does a time-limited cobranding promotion with a movie studio to support a movie launch, e.g., by distributing toys or other specialty items using the movie studio's characters or trademarks. Additionally, trademark controls meant to protect the trademark owners' legal rights in the mark do

37. U.S. FED. TRADE COMM'N, FRANCHISE RULE 16 C.F.R. PART 436: COMPLIANCE GUIDE 1 (2008) [hereinafter FRANCHISE RULE COMPLIANCE GUIDE]; 16 C.F.R. § 436.8(a)(1) (2011) (elevating minimum payment from $500 to $615).

38. FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 37, at 1 ("The name given to the business arrangement is irrelevant in determining whether it is covered by the amended Rule.").

39. *Id.*

40. *Id.* ("[T]he amended Rule covers relationships that are represented either orally or in writing as having characteristics specified in the amended Rule's definition of 'franchise.'").

41. *Id.* at 2.

42. *Id.*

43. *Id.* at 3.

44. *Id.* at 4 ("Promotional activities, in the absence of additional forms of assistance, will not be deemed 'significant.'").

not rise to the level of "significant control."[45]

The third element, the "payment" element, is also broadly defined. The "payment" element requires that a purchaser pay to the franchisor a minimum of $615 within the first six months of operating the franchise.[46] An exception to the payment element, nicknamed the "inventory exception," excludes payments for the purchase of a non-excessive amount of inventory at a bona fide wholesale price meant for resale or lease.[47] Thus, goods that a franchisee requires to operate its business, such as equipment, may not count towards the "payment" required to create a franchise arrangement.[48] Some states, however, have more strictly applied the "payment" element to specifically relate to investment in the franchise business, and therefore exclude certain garden-variety start-up costs that might be incurred in any business (such as telephone lines, computers, and other "ordinary business expenses").[49]

The federal law has some other exceptions as well. The federal law no longer applies to the sale of business opportunities, nor to the sale of franchises to be located outside of the United States.[50] Additionally, several exceptions may apply, even where the elements of a franchise are met.[51] One exception is referred to as a "fractional franchise," where (1) the franchisee or any of its officers or directors have more than two years of experience in the same line of business as the franchisor; and (2) sales resulting from the franchise relationship are not anticipated to exceed twenty percent of the franchisee's total sales in the first year of operation.[52] Federal law also exempts franchise offers or sales where the franchisee initially invests at least $1 million or where the franchisee is a

45. *Id.* at 4. For example, in *Thueson v. U-Haul Int'l, Inc.*, direct costs of the telephone line were paid by the licensee to the licensor, who then forwarded monthly payments to the telephone company. 50 Cal. Rptr. 3d 669, 675 (2006). The court claimed that this arrangement allowed the licensor to safeguard its trademark rights in its name and held that the licensor did not exert significant control. *Id.* at 676.

46. FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 37, at 4–5; 16 C.F.R. § 436.8(a)(1). A payment may include, but is not limited to, any of the following: "initial franchise fee; rent; advertising assistance; equipment and supplies . . . ; training; security deposits; escrow deposits; . . . promotional literature; equipment rental; and continuing royalties on sales." FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 37, at 5.

47. FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 37, at 6.

48. *Id.*

49. *Thueson*, 50 Cal. Rptr. 3d at 674–76 (finding certain expenses did not constitute a "franchise fee," and citing Michigan, Washington, and Minnesota law for support).

50. FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 37, at 6. Therefore, the rule does not apply where the franchise is sold to an individual, regardless of nationality, when the outlet will be located in a foreign country. The rule only applies where the franchise is to be located in the United States and its territories. *Id.*

51. *Id.* at 7.

52. *Id.* at 8.

large business. The initial investment does not include costs associated with land or future obligations to pay a franchisor for royalties or rent.[53] In order to meet the large-franchisee exemption, the franchisee must have "been in business for at least five years and have a net worth of at least $5 million."[54] Finally, the "insiders" exemption allows officers, directors, general partners, or managers of the franchisor to avoid the federal rule.[55] To meet the exemption, an officer would need to agree to purchase more than fifty percent ownership in the franchise and must have two years' work experience as one of the aforementioned titles with the franchisor.[56]

Another relevant exception is the Single Trademark License Exclusion. The federal rule excludes trademark-license arrangements from being deemed franchise arrangements where the trademark has been licensed to only a single licensee.[57] This includes typical one-on-one licensing arrangements as well as collateral-product licensing wherein a trademark well known in one context is licensed for use in another.[58]

The above federal laws set a minimum standard for franchise arrangements. As one might expect, states have enacted additional franchise rules, considered below.

2. State Franchise Disclosure Rules

Several states, known as "Franchise Registration States," require that in addition to following federal franchise laws, franchise agreements are subject to supplemental franchise laws, and franchisors must register their Franchise Disclosure Document with the state before offering or selling the franchise.[59] Franchisors are required to issue an FDD and disclose it to the prospective franchisee more than fourteen days before the franchise agreement or the payment of any fees.[60] These franchise registration states include California, Maryland, New York, Rhode Island, Michigan, Indiana, Illinois, Wisconsin, Minnesota, and Washington.[61] Connecticut,

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53. *Id*. at 10.
54. *Id*. at 12.
55. *Id*. at 13–14.
56. *Id*. at 14. The franchisee must have also been associated with the franchisor within the past sixty days of the proposed sale. *Id.*
57. *Id*. at 16.
58. *Id*.
59. *The Franchise Registration States*, INTERNICOLA LAW FIRM (Feb. 24, 2015), https://www.franchiselawsolutions.com/blog/the-franchise-registration-states/ [https://perma.cc/QT76-NC4U].
60. *Id*.
61. *Id*. *See generally* CAL. CORP. CODE § 31110 (West 2021); MD. CODE ANN. BUS. REG. § 14-214 (West 2021); N.Y. GEN. BUS. LAW § 683 (McKinny 2021); R.I. GEN. LAWS ANN. § 19-28.1-

North Carolina, South Carolina, and Maine also require registration of the FDD if the franchisor has not registered its trademarks with the U.S. Patent and Trademark Office.[62]

Additionally, some states have implemented "supplemental franchise or business-opportunity laws that require franchisors to submit a franchise filing with the state."[63] This filing is typically a simple notice to the state. Such notice is required for the following states: Connecticut, Florida, Kentucky, Nebraska, North Carolina, South Carolina, South Dakota, Texas, and Utah. Georgia and Louisiana require filings if the franchisors do not have federally registered trademarks.[64]

C. Deviations from the National Standard

As one might imagine, some states are friendlier to franchisees than the national requirement, whereas some states rely entirely on the national standards rooted in the FTC rules.

1. States Franchisors Should Avoid

Franchise Registration States such as Virginia, Wisconsin, Maryland, New York, and Hawaii provide few exceptions to the state franchise laws. For instance, New York has a narrower out-of-state exception than most other states. In New York, the state's franchise law is applied expansively to all franchise sales in which the franchise is sold, offered, or offered for sale in New York, or the offer is made from New York.[65] Therefore, New York franchise law may apply to franchisors who conduct their business in New York, even if the franchisor is engaged in an out-of-state franchise sale where the franchise will be operated in a state other than New York.[66]

Additionally, Hawaii offers a very broad definition of a franchise relationship, i.e., a trademark license in exchange for a direct or indirect

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5 (West 2018); MICH. COMP. LAWS § 445.1507a (1974); IND. CODE. ANN. § 23-2-2.5-9 (2018); 815 ILL. COMP STAT. 705/10 (2009); WIS. STAT. § 553.21 (1995); MINN. STAT. § 80C.02 (1973); WASH. REV. CODE § 19.100.020 (2012). *See also infra* Table 1, Franchise Registration and Filing Requirements by State.

62. *The Franchise Registration States*, *supra* note 59. *See generally* CONN. GEN. STAT. § 36b-61(2)(D) (2013); N.C. GEN. STAT. § 66–94(4) (2014); S.C. CODE ANN. § 39-57-20(4) (2012); ME. STAT. tit. 32-69 § 4691(3)(A)(4) (1991).

63. *The Franchise Registration States*, *supra* note 59.

64. *Id.*

65. *New York State Franchise Registration: FDD Registration*, INTERNICOLA LAW FIRM, https://www.franchiselawsolutions.com/franchising/new-york-franchise-registration/ [https://perma.cc/JDJ9-SV6B] (last visited Aug. 29, 2021) [hereinafter *New York State*]; N.Y. GEN. BUS. LAW § 683(1) (McKinney 2021).

66. *See New York State*, *supra* note 65 (discussing case law supporting that New York franchise law may be applicable to franchisors who conduct business outside New York).

franchise fee.[67] Hawaii also has limited exceptions to the franchise registration requirement, and an inadvertent licensor may easily be stuck in a franchise relationship.[68]

2. Examples of Franchisee-Friendly State Laws

Many Franchise Registration States, such as Hawaii, California, Illinois, Minnesota, and Washington, have also enacted franchise-relationship laws that include additional franchisee-friendly regulations.[69] These laws vary in scope, but in essence they provide franchisees with additional rights in the franchisor-franchisee relationship. Whereas franchise-disclosure laws are meant to address concerns before the franchisor and franchisee enter into a franchise relationship, franchise-relationship laws are meant to regulate franchisors after the franchisee enters into the relationship.[70]

There is no federal franchise-relationship law, and the laws vary from state to state.[71] But these laws generally limit the franchisor's right to (1) terminate the franchise relationship; (2) fail to renew the franchise; and (3) fail to approve the franchisee's transfer of ownership.[72] Additionally, many states prohibit the disparate treatment of franchisees and impose good-faith standards.[73]

As an example, Hawaii's franchise-relationship law governs contracts between franchisors (or subfranchisors) and franchisees, ensuring extra protections for the franchisee beyond the registration requirement.[74] For instance, both parties must deal with each other in good faith. In addition, the law prohibits unfair or deceptive acts by the franchisor as defined in the statute itself.[75] This includes restricting the right of franchisees to join an association of franchisees and/or requiring franchisees to purchase or lease goods or services of the franchisor or from designated sources

67. *Hawaii Franchise Filing and FDD Registration: Hawaii Franchise Laws*, INTERNICOLA LAW FIRM, https://www.franchiselawsolutions.com/franchising/hawaii-franchise-registration/ [https://perma.cc/EYF6-YVWJ] (last visited Aug. 29, 2021) [hereinafter *Hawaii Franchise Laws*]; HAW. REV. STAT. § 482E-2 (2013).

68. *Hawaii Franchise Laws*, *supra* note 67; HAW. REV. STAT. § 482E-4 (2013).

69. *See Complying with Franchise Relationship Laws*, LUSTHAUS LAW P.C., https://lusthaus-franchiselaw.com/services-for-franchisors/complying-with-franchise-relationship-laws/ [https://perma.cc/H7G8-MUVN] (last visited Aug. 29, 2021) (providing a full list of states with franchise-relationship laws).

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*

74. HAW. REV. STAT. § 482E-6 (2013).

75. *Id.* § 482E-6(2).

unless reasonably necessary for a lawful purpose on business grounds.[76] In addition, Hawaii prohibits franchisors from discriminating between franchisees regarding the charges for royalties, goods, services, equipment, advertisements, or any other business dealings (barring some exceptions).[77]

As further protection for franchisees, Hawaii's franchise-relationship law prevents franchisors from establishing a competing business with the franchisee or granting another similar franchise in the same geographical area of the franchisee. A franchisor must also have good cause to terminate, refuse to renew a franchise, or refuse to permit a transfer of ownership of a franchise. And upon termination or refusal to renew the franchise, the franchisor must compensate the franchisee at fair market value and repurchase the franchisee's inventory, supplies, and equipment supplied by the franchisor. Importantly, if the franchisor fails to renew the franchise for the purpose of converting the franchisee's business into one owned and operated directly by the franchisor, the franchisee will be entitled to compensation for the loss of goodwill.[78]

Finally, if a franchisor violates any of the provisions of Hawaii's franchise-relationship law, franchisees are entitled to damages based on "reasonable approximations."[79]

Of the states that have franchise-relationship laws, many include the same franchisee protections or similar variations of the above franchise-relationship law. For instance, while California and Minnesota have similar provisions to Hawaii's franchise-relationship law, they include several minor differences that impact the rights of the franchisor and franchisee.

In particular, California's franchise-relationship law does not necessarily require "good cause" for the franchisor to fail to renew the franchise.[80] In California, the franchisor must merely provide 180 days' notice and meet one of several other requirements, including but not limited to agreeing not to convert the franchisee's business into the franchisor's own, or permitting the franchisee to sell the business to another purchaser meeting the franchisor's current requirements.[81]

In Minnesota, the franchise-relationship laws are governed by a single

76. *Id.*
77. *Id.* § 482E-6(2)(C).
78. *Id.* § 482E-6(3).
79. *Id.* § 482E-6(5).
80. CAL. BUS. & PROF. CODE § 20025 (West 2021).
81. *Id.*

provision in the state's Franchise Act.[82] Minnesota's franchise-relationship law provides fewer protections to franchisees than Hawaii's and merely includes provisions to protect franchisees from termination/failure to renew the franchise without good cause as well as to prevent franchisors from unreasonably withholding consent to assign, transfer, or sell the franchise.[83]

Trademark licensors should beware the additional rights granted to franchisees from franchise-relationship laws. Particularly, if a licensor were to accidentally enter into a franchise agreement in one of these states, they would be unlikely to be able to immediately terminate the franchise without being subject to damages. Many states include ninety days' notice, as well as good cause, to end the relationship. In addition, as shown above, state law may include several other provisions limiting the rights of the licensor/franchisor. These limitations expose the licensor to potential liability. Therefore, extra care should be taken when licensing a trademark in these jurisdictions.

3. Examples of Franchisor-Friendly State Laws

States such as Massachusetts and New Hampshire do not have state franchise registration or filing laws and do not have the same protections for franchisees as stated above.[84] But the federal franchise law still applies, and these states must follow the FTC guidelines.[85] Many states do not require franchise registration at the state level; however, in some cases agreements may fall under local business-opportunity laws. These laws are designed to protect buyers by requiring the seller of a business opportunity to provide a pre-sale disclosure and other information. These laws vary from state to state; however, many states carve out exceptions for trademark licenses.

For instance, in Arizona, a business opportunity does not include a sales program or marketing program offered in connection with a trademark license (so long as the trademark is registered under federal law).[86]

Similarly, Iowa offers an exception to its business-opportunity law so long as the business opportunity involves a marketing plan in connection

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82. MINN. STAT. ANN. § 80C.14 (2020).
83. *Id.*
84. *State Specific Laws*, INTERNICOLA LAW FIRM, https://www.franchiselawsolutions.com/franchising/state-specific-laws/ [https://perma.cc/WU4Q-HUZ8] (last visited Aug. 29, 2021); *What Are the Business Opportunity Laws?*, INTERNICOLA LAW FIRM, https://www.franchiselawsolutions.com/faqs/business-opportunity-laws/ [https://perma.cc/CC8P-EYJE] (last visited Aug. 29, 2021).
85. *See supra* Section IV.B.1 (discussing federal franchise laws).
86. ARIZ. REV. STAT. ANN. § 44-1271(1)(b)(vi) (2021).

with a trademark license (for a federally registered mark) and the seller has a minimum net worth of $1 million.[87] If this exception is not met, the licensor must prepare a disclosure document similar to the extensive requirements of a franchise disclosure.[88]

V. INTERSECTION OF THE FRANCHISE AGREEMENT AND TRADEMARK LICENSE

Trademark licensors must be aware of franchise laws, because a trademark license is one of the bedrock elements of a franchise. So long as the agreement meets the elements of a franchise, parties may be unable to avoid forming a franchise simply by claiming lack of intent.[89] Therefore, licensors must beware the possibility of an accidental franchise.

Accidental franchise claims typically arise where a licensor terminates a licensing contract without cause or makes a change to the license arrangement that prejudices the licensee.[90] Aggrieved licensees raise these claims in an effort to obtain greater rights in the franchise relationship than they might under a direct breach of contract theory (or if, under the trademark license agreement, they had no recourse at all). For instance, as noted above, several states prevent the termination of a franchise without cause.[91] This increases the licensee's rights and may, in effect, trap the licensor in the agreement, or at the very least, make it more difficult for the licensor to back out of the agreement. The licensor may also be subject to liability for violating state and/or federal laws.[92] The capability of raising a franchise claim shifts the balance of power in favor of the licensee.

Franchisors can protect themselves by working with an attorney to analyze the trademark license agreement in light of the federal and relevant state franchise definitions. Therefore, franchisors should consider the following elements when drafting a trademark license: the trademark license itself, the control over the licensee (i.e., a marketing plan or community of interest), and the license fee.[93]

87. IOWA CODE ANN. § 551A.1(2)(b) (2020).
88. IOWA CODE ANN. § 551A.3 (2017).
89. Rochelle Spandorf, *Structuring Licenses to Avoid the Inadvertent Franchise*, LANDSLIDE, Mar./Apr. 2010, at 37, 37.
90. Rochelle B. Spandorf, *Expert Q&A on Trademark Licensing and Accidental Franchises*, PRAC. L., Apr. 2016, at 16, 17.
91. *See supra* Section IV.B.3.
92. *See, e.g.*, ME. REV. STAT. ANN. tit. 10, § 1171-B(3) (2003); CAL. CORP. CODE § 31400(a) (West 1986); HAW. REV. STAT. § 482E-10.5 (1988); 815 ILL. COMP. STAT. 705/22(a)–(b) (2009); WASH. REV. CODE § 19.100.020 (2012).
93. Spandorf, *supra* note 90, at 16–17.

Not every trademark license creates a franchise, but every franchise has some form of trademark license. This element is difficult to avoid. In fact, this element can be met even without an express trademark license.[94] Some states merely require substantial association between a licensee's business and the licensor's trademark.[95]

The control element may also be difficult to avoid. Each state uses a slightly different analysis for this element. But franchisors should try to avoid employing substantial control over the franchisee. Restrictions on the licensee's customers, management or personnel advice, confinement of sales to an assigned territory, and even suggestions on retail prices and discounts may lead to a finding of substantial control.[96] States such as Hawaii employ the simple "community of interest" standard, which merely requires that both parties derive revenue from the licensee's sale of branded goods and services.[97] Therefore, these first two elements may be difficult to avoid.

Concerning the franchise fee element, the federal definition requires the licensee to pay $615 within the first six months of the franchise.[98] This can be avoided by prolonging the payment schedule for the trademark license. But under certain state laws, an agreement may become a franchise over time if the payments eventually cross the state-imposed fee requirement.[99]

Finally, some states have many exceptions to the state franchise laws, while others do not. These exceptions may include out-of-state licenses and other exceptions for large franchisees.[100]

A. Specific Cases of Accidental Franchise Litigation

The minefields present at the intersection of trademark and franchise law are not merely academic, but have arisen in numerous real-world transactions, many of which have made their way into the courts. We address a few such cases. These cases offer both warnings to licensors and insights into how courts might view these land mines if stepped on.

In our first example, Gap Inc.'s Middle East distributor, Gabana, sued

94. *Id.* at 17.
95. *Id.*
96. *Id.* at 18.
97. *See generally* Cycle City, Ltd. v. Harley-Davidson Motor Co., No. 14-00148, 2015 WL 3407825, at *5, *8–*9 (D. Haw. May 26, 2015) (using a community- of-interest standard to determine whether license agreement constituted a franchise).
98. 16 C.F.R. § 436.8(a)(1) (2020).
99. Spandorf, *supra* note 90, at 18–19.
100. *See, e.g.*, *New York State*, *supra* note 65 (noting that certain states have enacted supplemental franchise laws requiring franchisors to submit a franchise filing with the state).

after Gap terminated their agreement without cause.[101] The distribution agreement gave Gap substantial control over Gabana's operations.[102] For instance, Gabana needed written approval for its customers and its retail store locations where Gap products would be sold.[103] Gabana needed to provide retailers with a copy of Gap's advertising and sales restrictions and was in charge of monitoring compliance with these policies.[104] Gabana was also restricted from using or advertising any Gap trademarks other than those placed on Gap products or using the Gap trademark on business cards.[105] While Gap exercised substantial control over Gabana, the California definition of a franchise required "substantial association" between the franchisor's mark and the franchisee. Because the agreement forbade Gabana from adopting as its own any Gap trademark that might be considered to carry the risk of association with Gap, Gabana failed to establish that its customers associated Gabana with the Gap trademark.[106] Therefore, after several years of litigation, the court ruled in Gap's favor that the distribution arrangement was not a franchise.[107]

In another California case, the court declined to grant a defendant's motion to dismiss a plaintiff's franchise claims. Macedonia Distributing, Inc. alleged that its distributor agreement with S-L Distribution Co. created a franchise agreement between the parties.[108] The court found that Macedonia produced sufficient evidence that its customers considered Macedonia and S-L to be part of the same company, therefore forming a substantial association.[109] The court also found sufficient evidence that Macedonia paid S-L a franchise fee. Under the agreement, Macedonia paid $62,040 for the exclusive right to distribute authorized products to authorized outlets within a territory.[110] Even though Macedonia had the ability to resell within this territory, the court found this payment sufficient to constitute a franchise fee.[111] Finally, the court found Macedonia produced sufficient evidence of a marketing plan, thereby sufficiently

101. Gabana Gulf Distrib., Ltd. v. Gap Int'l Sales, Inc., No. C 06-02584, 2008 WL 111223, at *1–*3 (N.D. Cal. Jan. 9, 2008), *aff'd*, 343 F. App'x 258 (9th Cir. 2009).
102. *Id.* at *2.
103. *Id.*
104. *Id.*
105. *Id.*
106. *Id.* at *5–*6.
107. *Id.*; *see also* Spandorf, *supra* note 90, at 17 (summarizing result of Gap's litigation with Gabana Gulf).
108. Macedonia Distrib., Inc. v. S-L Distrib. Co., No. SACV 17-1692, 2018 WL 6190592, at *1 (C.D. Cal. Aug. 7, 2018).
109. *Id.* at *6.
110. *Id.*
111. *Id.*

alleging all three elements of a franchise.[112] Specifically, the court looked to evidence that Macedonia operated within an exclusive territory and that S-L established uniform pricing and control over the authorized outlet's payment and billing.[113] "Additionally, S-L provided Macedonia with marketing materials produced by manufacturers to distribute to authorized outlets."[114] This evidence provided sufficient support for Macedonia's contention that the distributor agreement with S-L formed a franchise, and the court declined to grant S-L's motion to dismiss.[115]

In Hawaii, the district court declined to dismiss Cycle City's franchise claims against Harley-Davidson.[116] Here, the license agreement required that Cycle City pay royalties for the duration of the agreement. The court found that these payments met the franchise-fee requirement and that the arrangement did not meet the exclusions to the franchise-fee definition.[117] The court also found that the license agreement met the "community of interest" element of a franchise under Hawaii state law.[118] A community of interest is found where there is a continuing financial interest between the parties in continuing operation of the franchise.[119] The court pointed to the royalty fees, as well as requirements that Cycle City obtain Harley-Davidson approval before it produced licensed products as evidence of a "community of interest."

In contrast, in a Washington-based case, the Ninth Circuit declined to find that a contract relationship established a franchise.[120] Here, the operator of a self-service gas station, Blanton, brought an action against the owner, Texaco, asserting that the contract relationship established a franchise when Texaco chose to terminate its contract with Blanton.[121] The contract gave Blanton operating control of the convenience store, negotiated a wage for Blanton, and gave Blanton various duties, such as advertising and pricing.[122] A dispute as to Blanton's wage resulted in Texaco's termination of the agreement, and Blanton sued for violation of the state's

112. *Id.* at *8.
113. *Id.* at *7.
114. *Id.*
115. *Id.* at *8.
116. Cycle City, Ltd. v. Harley-Davidson Motor Co., No. 14-00148, 2015 WL 3407825, at *1 (D. Haw. May 26, 2015).
117. *Id.* at *7–*8.
118. *Id.* at *9.
119. *Id.* at *8 n.1 (citing Girl Scouts of Manitou Council, Inc. v. Girl Scouts of U.S. of America, Inc., 549 F.3d 1079, 1093 (7th Cir. 2008) (applying WIS. STAT. § 135.02(1))).
120. Blanton v. Texaco Refin. & Mktg., Inc., 914 F.2d 188, 191 (9th Cir. 1990).
121. *Id.* at 189–190.
122. *Id.* at 189.

franchise law.[123]

The court focused its analysis on the "community interest" element of the franchise.[124] The court cited the leading Washington State case on community interest,[125] which stated that a community interest in the business refers to a continuing financial interest between a franchisor and franchisee, meaning that there is neither control by the company over the distributor (like an employer-employee relationship), nor is there sharing of the profits as in a partnership.[126] The court gave a specific example of such a community interest: "a purchase agreement coupled with a supply contract for a definite term indicates a continuing financial interest in the resale of the merchandise."[127] Blanton contended that his hourly wage was based in part on Texaco's motor-fuel sales revenue and his own convenience-store revenue, thus creating a community interest.[128] The court found that there was no relationship between Blanton's hourly wage and Texaco's motor-fuel sales, and instead market forces determined Blanton's hourly wage.[129] Therefore, the court held the contract did not establish a community of interest, so Texaco did not violate Washington franchise law by terminating Blanton.[130]

In Minnesota, a trademark license between Utecht Bakeries and U-Bake Rochester gave rise to a dispute where U-Bake contended that the trademark license constituted a franchise under the Minnesota Franchise Act.[131] U-Bake was a Minnesota entity, and Utecht was a Wisconsin-based frozen dough and bulk-foods store.[132] Utecht Bakeries "entered into several trademark license agreements granting the right to use the U-BAKE trademark with stores located mostly in Wisconsin."[133] In meetings with Utecht, U-Bake Rochester was informed that they would be licensing the U-BAKE trademark and that the license was "not a

123. *Id.* at 189–190.
124. *Id.* at 190–91.
125. *See id.* (citing Lobdell v. Sugar 'N Spice, Inc., 658 P.2d 1267, 1271 (Wash. Ct. App. 1983) (defining community interest as a continuing financial interest)).
126. *Id.*
127. *Id.* at 191 (citing *Lobdell*, 658 P.2d at 1274).
128. *Id.*
129. *Id.*
130. *Id.* The original contract included a schedule that computed the hourly wage as related to the volume of convenience store sales. *Id.* But because this schedule was never used and because Blanton admitted that the wage was never calculated in such matter, the court did not consider this evidence. *Id.*
131. U-Bake Rochester, LLC v. Utecht, No. 12-1738, 2014 WL 223439, at *1 (D. Minn. Jan. 21, 2014).
132. *Id.*
133. *Id.*

franchise."[134] U-Bake Rochester drafted a business plan that touted the benefits of not being a franchise.

The trademark license agreement required U-Bake Rochester to pay Utecht a license fee of $30,000 and 2.5% of its monthly gross receipts.[135] The agreement also had provisions stating that Utecht would assist and advise the licensee with the inventory ordering process and bookkeeping process, and that it would introduce the licensee to the appropriate suppliers of inventory.[136] Additionally, a Utecht Bakeries employee would supervise the business for two weeks to assist with the day-to-day operations of the store, including training the employees, and instructions on the process of baking the various bulk foods.[137]

Utecht included several provisions further defining the agreement. First, Utecht agreed not to "exercise any control over [or furnish assistance to U-Bake's] Method of Operation, Business Organization, Promotional Activities, Management, Marketing Plan or Business Affairs."[138] Another provision required "[U-Bake to] acknowledge[] that Utecht [was] not . . . a franchiser, and that the relationship between [U-Bake] and Utecht [was] not a franchise relationship . . . ."[139]

Several months later, U-Bake sued Utecht alleging that Utecht failed to meet the statutory registration and disclosure requirements under the Wisconsin and Minnesota franchise laws.[140] Utecht relied on the defense of estoppel against U-Bake's claims.[141] The court held that U-Bake was estopped from claiming Utecht violated Minnesota's and Wisconsin's franchise laws because U-Bake had a clear understanding that the license was not a franchise agreement, and U-Bake had expressly stated to the Small Business Association (SBA) that it was not a franchise relationship.[142]

The court analyzed whether this agreement fell within the purpose of franchise law and found that the informed and deliberate negotiation process, U-Bake's attorney's active involvement in revising the agreement, and U-Bake's adoption of the no-franchise position when it inured to their benefit, were evidence against finding that this agreement constituted a

134. *Id.* at *2.
135. *Id.*
136. *Id.* at *3.
137. *Id.*
138. *Id.*
139. *Id.*
140. *Id.* at *4.
141. *Id.*
142. *Id.* at *6.

franchise.[143]

In another Illinois case, a court found that that the elements of the franchise were met and that the defendant failed to provide an effective disclosure statement as required under the Illinois Franchise Act.[144] In this case, plaintiff (Salkeld) responded to an ad in a Chicago newspaper seeking individuals to distribute a product called "Cocktails Naturally."[145] Plaintiff and defendant (Innovative Concepts) met to discuss the details of the agreement. At the meeting, plaintiff was given documents titled "Sales Manual" and "Innovative Concepts Sub Licensee Program" which highlighted the operating procedures of the company and provided details on the support plaintiff could expect from defendant.[146] The document claimed that plaintiff could expect defendant to assist in "marketing[,] . . . sublicensee training, training (and hiring) of the sales staff, advertising and promotional material, sponsorship of sales contests . . . , national advertising, trade shows, corporate sales and much more."[147]

Plaintiff and defendant entered into a sublicensing agreement, with plaintiff agreeing to pay $22,500 to Innovative Concepts for a term of twenty years.[148] After plaintiff struggled to make sales and realized there was direct competition to Cocktails Naturally from multiple companies, plaintiff filed suit against defendant on several grounds, including violation of the Illinois Franchise Act.[149] The trial court granted defendant's motion for a directed verdict.[150] On appeal, plaintiff contended that the trial court erred in finding that the Illinois Franchise Act did not apply to the sublicensing agreement.[151]

After reviewing the record, the appellate court found that the "Sales Manual" and "Innovative Concepts Sub Licensee Program" were sufficient to satisfy the first element of a franchise in Illinois: the franchisee's right to engage in the business of distributing goods or services under a marketing plan.[152] Specifically, the "Sales Manual" provided information on how to demonstrate the product to potential consumers.[153] In addition, the "Innovative Concepts Sub Licensee Program" specifically stated that defendant was "with you [plaintiff] every step of the way" and promised

143. *Id.* at *7.
144. Salkeld v. V.R. Bus. Brokers, 548 N.E.2d 1151, 1156 (Ill. App. Ct. 1989).
145. *Id.* at 1152.
146. *Id.* at 1153.
147. *Id.*
148. *Id.* at 1153–54.
149. *Id.*
150. *Id.* at 1154.
151. *Id.* at 1155.
152. *Id.*
153. *Id.*

to support plaintiff with marketing, advertising, and training.[154]

The appellate court found that the other two elements of an Illinois Franchise were also met. The second element mainly concerned plaintiff's ability to use defendant's trademark, and the final element was based on a franchise fee. Here, the agreement at issue indicated that plaintiff was given the authority to use Cocktails Naturally trademarks.[155] Specifically, the agreement stated that "Licensee [is] granted certain rights to the use of trademarks, including COCKTAILS NATURALLY which has been registered with the Patent Office of the United States."[156] The court found this language to be sufficient to meet the second element of a franchise.[157] Finally, plaintiff's payment of $22,500 for the right to engage in the business was sufficient to meet the franchise-fee requirement.[158] Thus, the court reversed the trial court's findings and held the agreement constituted a franchise.[159] As a result, for failing to provide a franchise disclosure, defendant was forced to return plaintiff's $22,500 franchise fee, with interest, along with attorney's fees.[160]

In Connecticut, defendant (Allen-Bradley Company) brought an appeal and claimed that the trial court improperly found the existence of a franchise relationship between defendant and plaintiff (Hartford Electric Supply Company).[161] The Connecticut Franchise Act defined a franchise by two key elements: (1) the franchisee's right to sell or distribute goods under a marketing plan created by the franchisor, and (2) the franchisee's operation under such plan is substantially related to the franchisor's trademark.[162]

In the case at hand, the distributorship agreement governed the relationship between the parties.[163] The agreement required the plaintiff to prepare a business plan subject to the defendant's approval and required the plaintiff's employees to be trained extensively. In particular, the agreement stated "distributors are expected to participate in training conducted locally, at the factory and in regional locations."[164] In addition, the agreement gave the defendant substantial control over the plaintiff's inventory levels. For instance, the agreement the granted defendant

154. *Id.*
155. *Id.* at 1156.
156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.* at 1157.
161. Hartford Elec. Supply Co. v. Allen-Bradley Co., 736 A.2d 824, 827 (Conn. 1999).
162. *Id.* at 832.
163. *Id.* at 828.
164. *Id.*

"permission to determine the exact level and mix of inventory required."[165]

Additionally, the agreement required the plaintiff to maintain sales records of the defendant's products and allowed the defendant to set the price of its products. In fact, "the defendant print[ed] a catalog with sale prices for the plaintiff to use when selling the defendant's products."[166] Throughout the course of the agreement, the defendant placed the plaintiff on the "Distributor Concern Program," which was designed to assist distributors who allegedly underperformed.[167] The program indicated various areas requiring improvement such as training, staffing, sales performance, and sales promotion.[168]

Concerning the first element of a franchise, the court pointed to several key factors. First, the plaintiff's business plan was subject to the defendant's approval, and once approved, it became the defendant's marketing plan, which it could enforce on the plaintiff.[169] Second, the defendant also had control over the pricing of defendant's products, which is the "most fundamental aspect of a marketing plan."[170] Third, the defendant used the implied threat of termination to pressure plaintiff into making personnel decisions and demanded that plaintiff's personnel attend training at specific schools that cooperated with the defendant.[171] In addition, defendant carefully monitored and required plaintiff to maintain a requisite amount of inventory of defendant's products.[172] Finally, the defendant required plaintiff to maintain sales records of defendant's products and allow defendant the right to examine these records and require audits.[173] Based on the above facts, the court held that defendant controlled plaintiff's marketing plan.[174]

Regarding the second element of a franchise, the court found that defendant's trademark was substantially associated with the business plan. In this case, the plaintiff distributed catalogs and other promotional material with the defendant's trademark and prominently displayed defendant's name on the plaintiff's premises.[175] In fact, the plaintiff was the leading distributor for the defendant's products in the state of Connecticut

165. *Id.*
166. *Id.*
167. *Id.*
168. *Id.*
169. *Id.* at 834.
170. *Id.*
171. *Id.* at 835
172. *Id.* at 836.
173. *Id.*
174. *Id.* at 837.
175. *Id.* at 837–38.

for fifty years.[176] The court found that these facts were sufficient to meet the second element of a franchise and upheld the trial court's finding that the agreement constituted a franchise.[177]

As demonstrated above, the intersection of trademark law and franchise law is a trap for the unwary. Ensuring the parties' arrangement is treated as intended requires knowledge of the many factors characterizing a franchise relationship, but also may require an in-depth understanding of which state law applies as courts in different states, applying different state law, might approach things differently.

VI. RECOMMENDATIONS

Throughout this article, we have identified many factors that affect how, and whether, a trademark licensor might inadvertently create a franchise relationship. In this section, we recap and expand on those recommendations.

The first and best piece of advice is to work with an attorney familiar with *both* trademark law and franchise law when preparing a license agreement or launching a licensing program. Many of the essential and common clauses of a trademark license need to be drafted with a level of care that a lawyer with knowledge of franchise law might bring, but which a trademark lawyer unfamiliar with franchise law might miss. Such clauses are the trademark license itself, the degree of control over the licensee's business, and the structure of the license fee. Each of those provisions—which are nearly universal in any trademark license—can be drafted to at least minimize the potential for the agreement to be considered a franchise agreement.

A. Clauses to Consider

Federal franchise law may be avoided so long as payment of the franchise fee is delayed by six months from the date of the agreement.[178] Yet many states do not provide this exception.[179] Some license provisions may help prevent the establishment of the substantial association element of a franchise. For instance, a provision that prevents a

176. *Id.* at 839.
177. *Id.* at 839.
178. *See* FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 37, at 1 ("[A] commercial business arrangement is a 'franchise' if it satisfies three definitional elements . . . . [including] a minimum payment of at least $500 during the first six months of operations. . . . A business arrangement described as a 'franchise' will not be covered unless it meets the three definitional elements in the amended Rule."); 16 C.F.R. § 436.8(a)(1) (2011) (elevating minimum franchise-fee payment from $500 to $615).
179. *See supra* Section IV.B.2. (discussing state-law variations on franchise regulations).

licensee/distributor from using the mark on any of the licensee's own goods and requires that the mark be used solely on the licensor's goods may be sufficient to avoid the definition of a franchise.[180]

Additionally, the degree of control required to form a franchise varies by state and is a question of fact.[181] A provision giving the licensee control over pricing, payment, and billing over products in connection with the mark may yield enough control to the licensee to avoid a franchise agreement.[182] Other activities to avoid include, for example, restrictions on the licensee's customers, the giving of management or personnel advice, confinement of sales to an assigned territory, and even suggestions on retail prices and discounts. Any of those provisions raise the likelihood that the licensor has substantial control over the licensee, potentially creating a franchise relationship.[183] As noted above, however, states such as Hawaii employ the simple "community of interest" standard, which merely requires that both parties derive revenue from the licensee's sale of branded goods and services to establish a franchise level of "control."[184]

It should also be noted that the mere inclusion of a clause such as "this Agreement is not a franchise agreement" or similar language is not determinative, and if the elements of a franchise are met, a court will not hesitate to conclude that the license agreement formed a franchise. Therefore, it is no "quick fix" to include such language as an attempt to get around potential issues with the other types of clauses identified above.

B. States to Be Aware of for Licensors

Broadly speaking, perhaps the best recommendation for a licensor is to avoid licensing transactions in states that have franchisee-favorable laws.

Because franchise laws vary by state, some states have broader franchise definitions and stricter franchise requirements than others. In particular, New York, Hawaii, Michigan, and Maryland have broad

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180. In this case, Gabana was a distributor for Gap products and was limited to placing the Gap mark on Gap goods. Gabana Gulf Distrib, Ltd. v. GAP Int'l, Inc., No. C 06–02584, 2008 WL 111223, at *5 (N.D. Cal. Jan. 9, 2008).

181. *See supra* Section IV.C (comparing franchise laws in various states, specifically noting how some state laws are more franchisee-friendly).

182. *Gabana*, 2008 WL 111223, at *7.

183. *See* FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 37, at 3 (listing examples of significant types of control a franchisor may exercise over a franchisee).

184. *See generally* Cycle City, Ltd. v. Harley-Davidson Motor Co., No. 14–00148, 2015 WL 3407825 (D. Haw. May 26, 2015) (using a community-of-interest standard to determine whether agreement constitutes a franchise).

franchise definitions and limited exceptions.[185] For example, New York allows a licensor to avoid entering into a franchise agreement if the franchise is created outside the state of New York. However, in New York, an offer over the internet may qualify as an "in-state" offer and subject the licensor to a franchise agreement.

In addition, states such as Hawaii, California, Illinois, Minnesota, and Washington have "franchise-relationship laws" that grant the licensee additional rights under the franchise agreement.[186] This may include liability for the licensor terminating the license without cause or without significant notice. In California, Minnesota, and Hawaii, for instance, if a licensor were to accidentally enter into a franchise agreement, they probably could not immediately terminate the franchise without liability for damages. Many states require ninety days' notice as well as good cause to end the relationship. Licensors and licensees should be aware of these states when entering into a trademark license agreement.

Importantly, a licensor should be aware that it will likely not avoid a particular state's franchise law by using a "choice-of-law" provision in the contract for a more "favorable" state. Many states have statutory provisions that can void choice-of-law provisions in a franchise contract. For example, Minnesota's statute provides that Minnesota franchise law will apply if the franchisee is located in Minnesota, regardless of the choice-of-law provision in the contract.[187] California also has a choice-of-law voiding statute, though it has been applied more flexibly.[188] A licensor who is hopeful of using a choice-of-law provision to avoid a more franchisee-friendly state should consider whether the licensee's home state's statutes would honor that choice-of-law provision. In addition, the licensor should have a sound reason for selecting a particular choice of law that relates to the licensor's business operations and license program.

C. State Summary

Truly national operations, with nationwide licensing programs, will certainly have challenges navigating all the different franchise laws

185. *See generally* MD. CODE ANN., BUS. REG. § 14–214 (West 1992); N.Y. GEN. BUS. LAW § 683 (McKinney 1982); MICH. COMP. LAWS § 445.1507a (1984).

186. *See Complying with Franchise Relationship Laws*, *supra* note 69 ("At the state level, however, franchisees have greater protections as several states [including California, Hawaii, Illinois, Minnesota, and Washington, among others] have specific franchise relationship laws.").

187. Hockey Enterprises, Inc. v. Total Hockey Worldwide, LLC, 762 F. Supp. 2d 1138, 1146 (D. Minn. 2011) (evaluating MINN. STAT. § 80C.21).

188. 1-800-Got Junk? LLC v. Superior Court, 189 Cal. App. 4th 500, 519–20 (Cal. Ct. App. 2010) (determining it was not against public policy to apply Washington's choice-of-law provision because Washington was closest United States jurisdiction to franchisor's headquarters in Vancouver, and franchisor had franchisees in multiple states).

across the country. There is no one piece of advice that can mitigate those risks. Rather, all of the recommendations above and throughout this article should be taken into account. That said, smaller-scale trademark-licensing programs, especially those executed on a more regional basis, can be executed with substantially more control and certainty around how those programs will be interpreted by focusing on the states in which the program is active.

Below is a broad summary of state requirements.[189] The chart is not meant to provide a full state-by-state survey of relevant laws, but is intended to provide a quick reference of where further research and legal advice might be needed, depending on the locus of the licensing activity. Of course, federal law should always be considered as well.

As always, particular care should be paid to whether a specific state has any kind of franchise-relationship laws. Such laws may be codified specifically under a "Franchise Law" portion of the code but may also be found in state codes relating to business transactions or business opportunities.

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189. *See State Specific Laws*, *supra* note 84 (summarizing franchise laws across states using an interactive map).

Table 1

FRANCHISE REGISTRATION AND FILING REQUIREMENTS BY STATE

FRANCHISE REGISTRATION REQUIRED (FRANCHISOR MUST FILE FRANCHISE DISCLOSURE DOCUMENTS)	FILING REQUIRED (FRANCHISOR MUST FILE A NOTICE THAT IT IS ENGAGING IN A FRANCHISE BUSINESS)	NO REGISTRATION OR FILING REQUIRED FOR FRANCHISE BUSINESS
California	Connecticut	Alabama
Hawaii	Florida	Alaska
Illinois	*Georgia***	Arizona
Indiana	Kentucky	Arkansas
Maryland	*Louisiana***	Colorado
Michigan	*Maine***	Delaware
Minnesota	Nebraska	Idaho
New York	*South Carolina****	Iowa
North Dakota	South Dakota	Kansas
*North Carolina****	Texas	Massachusetts
*Oregon**	Utah	Mississippi
Rhode Island		Missouri
Virginia		Montana
Washington		Nevada
Wisconsin		New Hampshire
		New Jersey
		New Mexico
		Ohio
		Oklahoma
		Pennsylvania
		Tennessee
		Vermont
		West Virginia
		Wyoming

* So long as the franchisor maintains a current FDD in accordance with the Federal Rule.
** No filing is required so long as the franchisor has a federally registered trademark.
*** No registration is required so long as the franchisor has a federally registered trademark. Instead, a one-time filing is required.

VII. Conclusion

Trademark law and franchise law are inexorably intertwined. While most attorneys and trademark owners have a general conceptual understanding of a trademark license and what it might be used for, few are also familiar with franchise law. That lack of familiarity can lead to serious unintended consequences.

Whereas trademark law and normal trademark-licensing law do not favor one side over the other, franchise law decidedly stacks the deck against the trademark owner. A licensee who becomes a franchisee (even inadvertently from the perspective of the trademark owner) has significant rights that a garden-variety trademark licensee does not have: it can prevent termination of the license; it can impose strict conditions on any termination by the licensor; and it can make a termination event a cause for payment of damages. Those outcomes can seriously hamstring the type of flexibility a trademark licensor would ordinarily expect in a trademark license and create significant exposure.

To navigate this area, a licensor should work closely with an attorney who understands the factors that might turn a trademark license into a franchise agreement. The licensor will want to be aware of which states are more favorable to franchisees and if possible, take those states into account in creating its licensing program. While not every trademark license is a franchise agreement, every franchise agreement is, at its heart, a trademark license. A trademark owner needs to know the difference.