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Fox Rothschild Podcast

Featuring Litigation Partner John Gotaskie in Pittsburgh

We are talking today about the topic of accidental franchising with John Gotaskie on Fox Rothschild Podcast. John is a partner and litigator with Fox Rothschild in Pittsburgh. He represents franchisors in diverse legal matters, including complex commercial litigation, creditor's rights and franchising issues as well as social media matters. John, good morning.

John Gotaskie: Good morning. Thank you.

***Question:** John, the term "accidental franchising" catches my ear, and I'm sure those of our listeners. What's it all about?*

John Gotaskie: A company unwittingly can become a franchisor without intending to franchise its business. This occurs in a variety of scenarios where companies seek to grow using third-party dealership, distribution or licensing deals to grow their sales. What the leaders of these growing companies may not know is that the federal and many state governments highly regulate such activities and that the regulations are significant. Even though they may not think of themselves as franchisors, in fact they could be in jeopardy of assuming major risk if their business structure falls within the regulations.

***Question:** John, how does this happen?*

John Gotaskie: Good question. Let's take the example of a company that allows a trademarked service or product it owns to be licensed or distributed by another, or sold via a dealership. To the government, this can have the appearance of a franchising arrangement.

***Question:** What are the potential pitfalls, John? What are the risks?*

John Gotaskie: It all starts with understanding how federal regulations issued by the Federal Trade Commission define franchise relationships. In the rules issued by the FTC, franchising may occur in one or more of the following scenarios:

- First, when a company allows a third party the right to use a product or service that carries the company's trademark.
- Second, when the third party must pay a fee, such as a royalty, to the company for the use of intellectual property such as trademarks or service marks.



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- Third, when the company that owns the trademarked product or service controls how a third party may use the product or service. And fourth, when the third party relies heavily on the company to provide instruction or coaching advice involving the product or service.

The key factors are permission to use a service mark, trademark or other commercial symbol, significant control over or assistance with operations, and fee or payment, some sort of royalty, to a licensor.

Question: Is the federal government the primary enforcer of franchising behavior?

John Gotaskie: In most cases, yes. While a majority of state governments do not have separate franchise rules, a significant minority actually have very detailed descriptions of what constitutes a franchisor.

Question: Can you go into detail?

John Gotaskie: Sure. States typically have two major definitions of a franchise. The first type is commonly called the “Marketing Plan.” In Marketing Plan states like Illinois or Indiana, one party agrees to grant another party the right to engage in a business that is proscribed by a marketing plan or system.

The other major type is the “Community of Interest” states. In these states, the parties have a common financial interest in the marketing and sale of a particular set of products or service. Significant states using this definition include New York and New Jersey.

It really comes down to degrees of independence between the parties. The whole idea of a franchise is to present a uniformly excellent customer experience at every franchise location, so the regulators look to see if those controls are in place. Things like geographic limitations on sales territory, certain sales quotas, or substantial use of logos or other branding are all factors that might be considered.

Question: John, it sounds like this would really restrict a lot of deals that have potential to generate good outcomes for both sides.

John Gotaskie: Let me say that I don’t believe that’s the case at all. One in nine jobs in the United States is at a franchised business and franchising is fully 11 percent of the U.S. non-farm economy. The numbers speak for themselves regarding the success of the franchise, licensing and distribution model at expanding the volume and geographic reach of a company’s sales.

Question: John, how does a CEO or business owner avoid hidden land mines in what seems to be a risky approach to growth?



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John Gotaskie: My job is all about helping business leaders mitigate risk. And the truth is that the solution is relatively simple. The key to avoiding noncompliance with the law in franchise relationships is first to be aware of the potential ways in which the law may deem your business to be a franchise. The next step is to ensure that your advertising and solicitation materials comply with the disclosure requirements of the regulations. The last step is to have very well, very carefully constructed written agreements that spell out the parties' relationship with great precision.

Question: Where are the trouble spots that you see?

John Gotaskie: Often, where the courts crack down on franchisors is in deals where the contract says one thing, but the behavior is another. It's really all about the control to which the third party must submit. And, the greater the control exerted by the company licensing the brand, the greater likelihood that the company is operating a franchise system.

Question: Where do these types of deals go wrong?

John Gotaskie: It's usually where the licensee or licensor becomes annoyed with the relationship for whatever reason and seeks legal help. It may be that he or she feels so restricted by the terms that they become discontented and ultimately pursue litigation to change the terms of the agreement or to otherwise change the agreement. Or, conversely, when a company believes its licensee is not living up to the terms of the contract and sues to enforce those terms.

Question: Can you give some examples?

John Gotaskie: Well about a decade ago, the United States Court of Appeals for the Seventh Circuit said "Legal terms often have specialized meanings that can surprise even a sophisticated party. The term 'franchise' . . . is one of those words." That's a direct quote from an opinion of the Seventh Circuit. I think that the court accurately captured the idea of the accidental franchisor. It is not something that is intentional, but the law defines what it is.

In that case, a forklift distributor sued the manufacturer claiming that the distribution contract was a hidden franchise. A jury agreed, awarding \$1.525 million in damages, and the appeals court affirmed.

Courts and juries have found franchise relationships in many types of dealer/distributor relationships, including oil change repair shops, furniture stores, slot machine sales and appliance sales, just to name a few.

Question: And the time and cost of the distractions of the litigation?



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John Gotaskie: They can be enormous. I already mentioned the \$1.525 million forklift distributor verdict. I also know of another case where the termination of a beer distributorship was held to be wrongful in light of that state's franchise laws and the jury there awarded \$10.2 million in damages.

Question: What other sort of fines or remedies can be assessed?

John Gotaskie: In addition to the civil damages for breach of contract that we've been talking about, there can be civil and criminal penalties under the FTC rules, which can include penalties personal to officers and directors of companies. Some of the states also permit so-called private actions, where individuals can sue to enforce the state regulations.

Question: What can a company do, John, to protect itself?

John Gotaskie: I would suggest that they need to be very, very careful and not go it alone. Clearly, because this area of the law is so fraught with the risk of litigation, companies should engage a lawyer with experience and knowledge of the nuances of franchising who can guide them and craft what should be an enforceable contract.

Narrator: Well, thank you John. Listeners, to confidentially discuss whether your company may be at risk of being an accidental franchisor, please contact John at 412-394-5528 or at jgotaskie – that's J-G-O-T-A-S-K-I-E – at foxrothschild.com.

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