

Founder Fundamentals

What's an Accidental Franchise, and Could I Be One?

What happens when you have a successful business and someone approaches you about opening one in his or her city? You may think that sounds like a great idea, but the thought of franchising seems so daunting that you decide to enter into a license agreement instead. It's not a franchise if it's called a license agreement, right?

WRONG. Your simple license agreement may have turned you into a franchisor, requiring you to comply with the Federal Trade Commission's Rule on Franchising (the FTC Rule) as well as certain state laws (depending on your location and that of the licensee/franchisee).

Under the FTC Rule, a franchise is a commercial relationship that has three main components:

- required payment;
 - license of a trademark;
- AND
- significant assistance or control in the method of operation.

While you may think it cannot be too hard to avoid this designation based on these three elements, it is actually quite easy to fall into the "accidental franchise" trap.

Generally, licensors seek to avoid being designated a franchise by not requiring a payment or not providing significant assistance or control over the franchisee's method of operation. If you are trying to avoid the franchise designation based on the omission of one of these two elements, it is important that you keep these points in mind:

1. The required payment element is interpreted very broadly. In addition to initial franchise fees and royalties, the "required payment" element includes most other payments paid to the franchisor

as required by contract. Required payments include any fees paid by the franchisee to the franchisor, whether for advertising, assistance, training, equipment and supplies (including such purchases from third parties that pay the franchisor for a franchisee's purchase) or almost anything else. There is a limited exception for genuine inventory purchases, but some state laws do not include that exception.

2. In interpreting the significant control/assistance element, such control or assistance may include "site design and appearance requirements," "personnel policies," "formal sales, repair or business training programs" or "furnishing management, marketing or personnel advice." Most trademark license agreements will contain some language regarding "quality control" and monitoring the goods or services provided under the licensor's mark, which could trip that element. In fact, a trademark holder has an affirmative obligation to monitor the goods or services provided under its mark. It

is important to utilize a carefully crafted trademark license agreement to walk this fine line and, in reality, not exert control over your licensee's business in practice. But consider, when a business is operating under your trade name, whether you would want to give up control over how that business operates.

3. The definition of a franchise under state law may not match the definition of a franchise under the FTC Rule. For example, of the 26 states that regulate the offer and sale of franchises, eight define a franchise as a business that operates under a "community of interest" with the licensor/franchisor, instead of the assistance/control element of the FTC Rule. The community of interest element generally captures a wider variety of business arrangements than the FTC Rule's assistance/control element such that a licensor may trigger state franchise law without realizing it. To make things more complicated, certain states omit the required payment element from their definition of a franchise.

The FTC Rule provides certain exemptions, which may reduce the regulatory

requirements of the rule — in particular the requirement to prepare and provide prospective franchisees with a franchise disclosure document, which is a significant undertaking. These exemptions include, for example, a high minimum payment by the franchisee, franchisees over a certain net worth or an insider exemption. Again, these exemptions do not align with underlying state law so, if you avail yourself of these exemptions, you may have to avoid doing business in certain states.

So, if you are approached about licensing your business to others, it is incredibly important that you not fall into the accidental franchise trap. You must either follow the franchise laws and regulations or carefully structure your business outside of these laws, which will require examination of both the FTC Rule and state law. We advise that you consult with an experienced franchise attorney prior to entering into any agreement governing this type of relationship, because some state statutes impose severe consequences for failure to comply with the restrictions on offers and sales of franchises in their states.

Fox Rothschild has a program for [Startup Franchisors](#). We are happy to consult with you about the requirements to franchise your business.



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