Licensing Versus Franchising

By Business and Franchise Lawyer
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Licensing Versus Franchising

As a successful business owner and entrepreneur, chances are that with the success of your business, you may be receiving inquiries and questions about your business: “whether your business is a franchise”, “whether or not you would consider franchising” and, if you are not a franchise, “whether or not they can invest in your business or open—with your assistance—their own business location”?

When this occurs (as it inevitably does), the natural “NEXT STEP” is to evaluate your options, learn about franchising and determine whether or not there are other options to franchising (such as “licensing”) and if “franchising” is the next step, how to get it done.

This article is not about “how to franchise your business” (something I discuss in many articles and in my book) but, rather, about “licensing” and whether “licensing” is an alternative to franchising.

Many times, licensing is presented as an alternative to franchising and, for many, the potential appeal of “licensing” is that it is perceived to be a “less expensive alternative to franchising.” However, while franchising is a regulated industry and there are, indeed, start-up costs and expenses associated with franchising your business, it is critical that you understand that licensing is not an alternative to franchising. In fact, as I will discuss in this article, licensing—when used as an alternative to franchising—is a TRAP that may damage your business and expose you to significant monetary damages.

The goal of this article is to provide you with practical information about: licensing, why licensing is not an alternative to franchising and, factors that should be considered regarding the expansion and growth of your business.

Sincerely,

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TABLE OF CONTENTS

The Unintentional Franchisor
How a License Agreement May Subject You to Franchise Regulation........................................1

Additional Information about Franchising..........................................................................................2

Could My Licensing Agreement be a Franchise?..............................................................................3

Franchise Agreements Versus License Agreements:
When Your License Agreement Violates the Franchise Laws.........................................................4

Blatant Franchise Violations:
Franchise Agreements Disguised as License Agreements...............................................................5

Franchising is a Business Expansion Model......................................................................................6

What are the Advantages to Franchising?.........................................................................................6

Franchising: Is It Right For Your Business?.......................................................................................7

4 Questions to Answer Before You Start a Franchise.......................................................................7
THE UNINTENTIONAL FRANCHISOR:
HOW A LICENSE AGREEMENT MAY SUBJECT YOU TO FRANCHISE REGULATION

“Franchising” has been and remains one of the most successful vehicles for the multi-unit expansion of a business. However, for many entrepreneurs looking to expand their business and brand, “franchising” is too often disregarded as a viable business model. For these entrepreneurs, the establishment of a franchise system (unnecessarily) appears to be a daunting task and is disregarded in favor of “licensing”. That is, in an “attempted” effort to avoid franchise regulation, but nevertheless achieve brand growth, the entrepreneur (as a “licensor”) licenses his or her trade name and trademarks to third parties (known as “licensees”) who conduct their own business utilizing the licensed marks. But is licensing an alternative to franchising? The Answer is no – licensing is not an alternative to franchising. But considering that you are in the process of evaluating your business growth options, I believe that it is important that I explain why. In the remainder of this article I will discuss licensing, why it is not a viable option and, why it may be a liability trap.

While “licensing” relationships, without question, possess a legitimate purpose, they are extremely limited and cannot serve as an “end-run” around franchise regulation or to achieve a franchise type relationship. That is, license agreements cannot be used to create “franchise-type relationships” without the franchise regulation. The reason for this is simple: in the world of franchise regulation, “substance” matters more than “form”, labels do not matter and just because you call something a “license” does not mean that it is not a “franchise”. In short, your license agreement (no matter what you call it) may in fact be a franchise.

So, how do you determine if your license agreement “crosses the line”? You ignore titles such as “licensor”, “licensee”, “consulting agreement”, “license fee” and “license agreement” and evaluate the “substance” of your business relationship. Under the federal Franchise Rule, the defining characteristics of a franchise include:

1) Continuing Commercial Relationship. A “continuing commercial relationship”;
2) Agreement. A written or oral “agreement”;  
3) License. The “license” of a trademark (although, sometimes this is not even required);  
4) Control / Obligation to Support. “Control” over your “licensees/franchisees” methods of operation, or, an obligation to “support” those operations, and  
5) Fee. The payment of a “fee”

Since, factors (1), (2) and (3) are, by necessity, inherent to both franchise and license agreements, the determination as to whether or not your license agreement “crosses the line” into franchise territory, boils down to an evaluation of “control” and “fees”. That is:

• Will you possess control over your “licensee’s” methods of operation, or, in the alternative, are you obligated to provide support to your “licensee’s” operations? And  
• Will you receive or be owed a fee as a condition for your “licensee” to commence its operations?

IF YOUR ANSWERS ARE “YES” THEN YOU MUST PROCEED WITH CAUTION AND CAREFULLY CONSIDER THE REALITY THAT YOUR BUSINESS RELATIONSHIP CONSTITUTES A “FRANCHISE”.

The Internicola Law Firm, PC
ADDITIONAL INFORMATION ABOUT LICENSING

LICENSING IS A COMPONENT TO FRANCHISING

It is important to understand that "licensing" is a component to "franchising". That is, every franchise includes a license but not every license is a franchise.

WHAT IS THE DIFFERENCE BETWEEN LICENSING AND FRANCHISING?

Licensing, traditionally, is limited to the grant (by a licensor) of a license permitting a third party (licensee) the right to utilize the licensor's trademarks. From a legal standpoint, franchising can be described as a "super license" where the franchisor grants the franchisee the license and right to use the franchisor's trademarks and systems. The "plus elements" that legally converts a license into a franchise (thereby subjecting the "licensor" to franchise regulation, sometimes includes:

a) Payment of an initial fee, no matter what you call it (i.e. franchise fee, license fee, training fee or consulting fee);
b) Payment of a royalty or a recurring obligation. Keep in mind that, sometimes, consistent product or service purchases may be viewed as a royalty;
c) Control over advertising programs.
d) Control over franchisee operations.

WHY YOU NEED TO PROCEED WITH CAUTION

[CAUTION]: From a legal standpoint licenses are extremely limited. Many times, what you believe to be or call a "license" is in fact a franchise. The laws vary among the states and, in many instances, are intentionally ambiguous. So, proceed with caution and before structuring and proceeding with a "licensing program" speak to your attorney to ensure that the proper restrictions are in place and that you do not cross the line into franchise territory. Consider if you may be better off by just structuring a franchise - many times, if not most, you will be much better off. [Benefits to Franchising] That is by establishing a franchise (once the heavy lifting is done, i.e., your FDD prepared and Franchise Agreement in place (a process that is completely manageable and cost effective) you will be left with a franchise structure that (a) will provide you with legal protection and a shield from unnecessary litigation, and (b) a business infrastructure focused on the development and expansion of your business and business systems.
COULD YOUR LICENSE AGREEMENT BE A FRANCHISE?

If you have a business and you have licensed certain aspects of that business (i.e. where others have opened their own locations using your products, services, trade dress and, possibly trademarks) then you must consider and evaluate the possibility that your business relationship may be a franchise. If it is a franchise, then there is a very real risk that you may be violating state and federal franchise laws and exposing your business to unnecessary exposure. To better assess whether or not your license relationship may, in fact, be a franchise, consider these 3 questions:

1. Is the licensee’s right to my business associated with, or identified by, my business name, trademark, or other commercial symbol?
2. Is my licensee required to make payments to my business?
3. Do I maintain a certain degree of control over my licensee’s operations, or offer them regular assistance?

If the answer to these 3 questions is yes, then you may have unknowingly entered into a franchisor/franchisee relationship. In this relationship, you are required by law to meet certain obligations. These obligations include registering a pre-offering franchise disclosure document that satisfies federal regulation issued by the FTC and state specific franchise disclosure and registration laws. You can learn more about the laws concerning franchise licensing by visiting our article library.
FRANCHISE AGREEMENTS VERSUS LICENSE AGREEMENTS: WHEN YOUR LICENSE AGREEMENT VIOLATES THE FRANCHISE LAWS

Surprisingly (even for a franchise lawyer) far too often clients present me with license agreements (including clients who previously sold a “license” and is now presented with a claim that he or she unlawfully sold a franchise) that, many times, are nothing other than a disguised franchise agreement. Other than using the word "License" instead of "Franchise", these agreements are every bit of a franchise agreement. What is worse, is the fact that the people drafting these agreements (hopefully not lawyers) are, actually, leaving a complete roadmap as to their intentions. That is, to save money now by avoiding compliance with the franchise laws (i.e., preparation and registration of FDD and Franchise Agreements), these proposed "licensors" are looking to expand now, sell licenses and then later convert to a franchise.

HOW DO I KNOW THIS? Because the people drafting these license agreements actually include a written agreement provision whereby the "licensee" must later assist the "licensor" in converting the license agreement into a franchise agreement. Here is an example of this "conversion language" (by the way, this language is something to absolutely avoid)

"Licensee agrees that in the event that Licensor applies to become a Franchisor...Licensee shall assist, by any reasonable means, Licensor in becoming franchisor... and in converting Licensee's licensed units into franchised units..."

Really? So if you are a business owner evaluating "licensing verses franchising", consider:

1. The conversion provision in the license agreement, by all accounts, is probably unenforceable;
2. The conversion language in the license agreement is a red flag and sign that your license is probably a franchise;
3. The license agreement (since it violates franchise laws) will expose you to future liability and result in a situation

If, you are currently a licensor who has gone down this road and you are now looking to convert your license agreements into a franchise, consider:

1. The quicker you act, the better off you will be;
2. Before taking any action, speak to your franchise lawyer about establishing a clear plan to convert your franchises, establish your FDD and compliance documents, and correct your prior action through disclosures to the applicable state regulatory authority.
3. Understand that you are not the first person to face this issue, and if you act honestly and in a precise way, this "oversight" may be resolved and corrected.
As a franchise lawyer you would think that I am used to this by now, but I am not. What I am referring to is the inadvertent (at least I hope so) disregard of the franchise laws and regulation by extremely successful and well-intentioned business owners who have expanded their brand through license agreements that are nothing other than a disguised franchise. These business owners (none of which are my client) have adopted "license agreements" that – other than avoiding the actual word "Franchise" - are absolutely franchise agreements. That is, these license agreements:

1. Establish a continuing commercial relationship;
2. Grant a license to use certain trademarks and intellectual property;
3. Permit the “licensor” to exert a significant amount of control over the “licensee’s” operations, i.e., all goods and products must be purchased from the “Licensor” and the “Licensee” must conform to the “Licensor's” standards for operation; and
4. Involve payment of a fee. These fees are sometimes hidden in product cost and other required purchases but they are still, nevertheless there.

Not only do these "license agreements" create a road map that would lead a regulator to absolutely conclude that a franchise relationship has been established, they actually take it a step further and include agreement language whereby the "licensee" agrees to obligate itself to assist the Licensor in converting the Licensee's "licensed business" into a franchise, should Licensor later "apply to become a franchisor".

Judging by the number of proposed "license agreements" that I have seen recently, I question and ask you to question the following:

- Are lawyers actually drafting these license agreement and, if so, do their clients really understand the significant exposure that they may be subjecting themselves to in the future, i.e., when you have a disgruntled “licensee” who consults with an experienced franchise lawyer or contacts the attorney general?
- If you have a successful business and you wish to expand, you must understand that for all but an extremely limited number of situations you will be required to satisfy the franchise laws and regulation.
- If you are a successful business owner that is looking to disguise a franchise as a license due to a lack of capital for preparation of a Franchise Disclosure Document and other franchise compliance activities, I can assure you that the cost savings is just not worth the future litigation risk and exposure. Worse, when you do eventually decide to franchise your business, I can assure you that your license agreements will constitute nothing other than expensive problems that you will be required to address.

MY RECOMMENDATION: When it comes to franchising, there are no shortcuts. "Dressing up" your franchise as a license, in the long-term, will not work and is not worth the future cost or risk.
FRANCHISING IS A BUSINESS EXPANSION MODEL

The good thing is that there are many vehicles for achieving business expansion. Not all will be right for you and, before making any decision, take the time to explore the facts. Consider both your "personal" goals and your "business" goals.

So, what are the benefits to franchising and is franchising right for your business?

First, it is important to understand that “franchising” is a business model designed to achieve multi-unit business expansion by “leveraging” the assets that you have already built. These assets include your products, services, trade name, business systems, business know how and marketing know how. From a legal perspective, “franchising” allows you to take these assets and to legally systematize, protect and license (yes, I have used the word “license”) these assets so that franchisees may, hopefully, duplicate your business

WHAT ARE THE ADVANTAGES TO FRANCHISING?

THE ADVANTAGES OF FRANCHISING, INCLUDE:

- **Multi-Unit Expansion.** Franchising is a vehicle for growth and expansion. Franchisors benefit from the expansion of their business through the efforts of franchisees;
- **Capitalized Expansion.** Business expansion requires the investment of new capital. To expand your business and open multiple units, typically, you will be required to invest your own funds or to borrow the funds. As a franchisor you will obtain the benefit of achieving unit expansion that is facilitated and capitalized by your franchisees—not you;
- **Managerial Talent.** Business expansion requires dedicated managerial talent. Assuming that you choose your franchisees wisely, franchising affords the benefit of dedicated operators who not only manage their franchised locations but who also have a vested equity interest in the business.
- **Additional Revenue Sources.** As a franchisor—depending on how your franchise agreements are structured—you will receive additional income streams in the form of on-going royalties paid to you by franchisees. These royalties are commonly paid on a monthly basis and based upon a fixed percentage of the franchisees gross sales.
- **Scalability.** Franchising is highly scalable and may be refined and customized to account for a broad range of franchised expansion. Franchise programs may be established for both (a) franchisors focused on large volume national growth, and (b) franchisors focused on low volume regional growth.
WHAT IS NEXT FOR YOUR BUSINESS?

The next step involves a personal and business assessment. Consider the stage of your business, your personal goals and whether or not franchising is right for you.

FRANCHISING: IS IT RIGHT FOR YOUR BUSINESS?

Franchising represents one of the most dominant and dynamic forms of distribution in the United States economy. With, by many measures, franchise sales constituting more than 33% of all United States retail sales, the impact and significance of franchising is pervasive, has led and will continue to lead successful business owners and entrepreneurs to the following question: "is franchising right for my business?" As with every important decision, there is no easy answer and a good decision requires a thorough assessment of your business, your management skills and the business systems and assets that you have established.

Starting with the disclaimer and fact that "franchising is not right for every successful business, if you are interested in franchising your business, below are four questions that you must evaluate and answer.

Answering these questions are not easy and require serious consideration and thought as to the direction of your business and your commitment to creating a franchise system and infrastructure that will honestly and competently provide franchisees with the "opportunity" to duplicate your business success. The prospect for franchisee profitability

4 QUESTIONS TO ANSWER BEFORE YOU START A FRANCHISE

If you are a successful business owner and entrepreneur, chances are that you have considered or, at least, thought about expanding your business through the establishment of a franchise system. That is, taking the trademark(s), services and business systems that you have created and licensing them to third parties (franchisees) who will then devote their own time and capital to expanding your business concept and, hopefully, benefit from the experience and success that you have achieved to date. No doubt, franchising is a popular and extraordinary vehicle (when done correctly) to achieve the multi-unit expansion of a business. However, the franchising is not right for every business or entrepreneur. Before "starting a franchise", consider the following 4 questions to evaluate if franchising is right for your business:

- **FRANCHISE QUESTION NO. 1 – “DO YOU HAVE BUSINESS SYSTEMS?”**

  Franchising is all about duplication, consistency and uniformity. That is, recreating, in each store / each franchisee's business, the unique qualities and customer experience that has made your business a success. To
recreate this success and franchise your business you cannot leave anything to chance and you must be able to identify, articulate, teach and recreate the "business systems" that "you" use to successfully operate your business. For example, the "business systems" that I am referring to will include your methods and procedures for (a) operating the business, (b) addressing and responding to customers/clients, (c) advertising, (d) preparing products or delivering services, (e) managing staff and (f) administration. There are more and these "systems" will vary from business to business. The good thing is that, as a successful business owner, deep down if you take an objective look at the things you do every day in operating your business, identifying your "systems" should be a straightforward task. But keep in mind that you must be able to quantify these systems (i.e., write them down), simplify them and teach them to your future franchisees.

- **FRANCHISE QUESTION NO. 2 – “CAN YOUR SYSTEMS BE TAUGHT TO FRANCHISEES?”**

Once you have identified your "systems" (See, Franchise Question No. 1) the next question is whether or not your "systems" may be taught to franchisees and carried out by them consistently on a day-to-day basis. Consistency is key and to establish a successful franchise your "systems" must be capable of duplication by your franchisees - to do this, your systems cannot be complex and must be "boiled down" to a set formula. If your business "systems" are extremely complex (a) your business may not be an appropriate model for franchising or (b) your franchise may require extremely experienced franchisees with industry experience similar to yours.

- **FRANCHISE QUESTION NO. 3 – “DO YOU HAVE A STRONG AND PROTECTABLE TRADemark?”**

One of the primary and core elements of a franchise and franchise system is its trademark(s). As a "franchisor" one of the primary assets that you will be licensing to your "franchisee(s)" is the right to use your Trademark(s). So you need to make sure that your trademarks are unique to your business and be capable of obtaining legal protection - that is your trademark cannot be a generic term, cannot be a name that is currently used by others and must be capable of registration with the United States Patent and Trademark Office.

- **FRANCHISE QUESTION NO. 4 – “WILL YOUR BUSINESS BE PROFITABLE FOR FRANCHISEES?”**

Right now I am certain that you can pinpoint the profits of "your business" on a monthly, if not weekly or daily basis. To franchise your business you must first ensure that (a) your own business possesses a consistent track record of profitability and growth and (b) that your franchisees (if they follow your "systems") will possess the opportunity for profitable growth. When making this "profitability analysis", unlike your own business, you must take into account (i) the royalties that the franchisee will be paying to you on a weekly or monthly basis, (ii) the fact that the franchisee may have higher operating costs than your established business, and (iii) the franchisee may be servicing debt obligations used to establish its business.
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