LEARN FRANCHISING

ULTIMATE GUIDE

LICENSING VS. FRANCHISING

IS THERE REALLY A DIFFERENCE?

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A Note from Charles N. Internicola

As a successful business owner and entrepreneur, chances are people have asked if your business is a franchise, if they can invest in your business or open their own location?

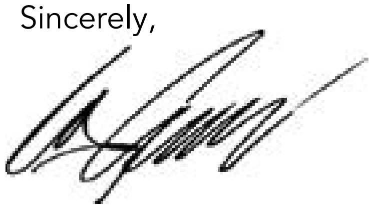
When this occurs, the natural next step is to evaluate your options, learn about franchising, and determine whether or not there are other options to franchising such as licensing. There's a lot of confusion if franchising is the next step for your business and how to get it done.

This guide is not about how to franchise your business—although it's something I discuss in many articles. Instead it's about licensing and whether it is an alternative to franchising.

Many times, people think licensing is an easier route to franchising. The appeal of licensing is that it's perceived to be a "less expensive alternative to franchising." However, while franchising is a regulated industry and there are startup costs and expenses associated with franchising your business, it is critical that you understand that licensing is not an alternative to franchising. In fact, 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. You'll learn why licensing is not an alternative to franchising and factors that should be considered regarding the expansion and growth of your business.

Sincerely,



Charles N. Internicola
Franchise Counsel for Emerging Brands

We believe all emerging brands can win big at franchising.

YOU MAY UNTENTIONALLY BE A FRANCHISOR

HOW A LICENSE AGREEMENT MAY SUBJECT YOU TO FRANCHISE REGULATION

Franchising is one of the most successful means for expanding almost any 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, establishing a franchise system unnecessarily appears to be a daunting task and is disregarded in favor of licensing.

So, when attempting to avoid franchise regulation while also growing their brand, an entrepreneur, the licensor, licenses his or her trade name and trademarks to third parties. These third parties are known as licensees and would conduct their own businesses while utilizing the licensed marks.

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. The rest of this guide discusses I licensing, why it's not a viable option, and why it may be a liability trap.

Without question, licensing relationships have a legitimate purpose. However, they are extremely limited and cannot get around franchise regulation. That is, license agreements cannot be used to create franchise-type relationships without franchise regulation. The reason for this is simple: In the world of franchise regulation, "substance" matters more than "form". 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?

Under the Federal Franchise Rule, a franchise is defined as:

1. A continuing commercial **relationship**
2. A written or oral **agreement**
3. The license of a **trademark** (although, sometimes this is not even required)
4. **Control** over your licensees'/franchisees' methods of operation or an obligation to **support** those operations
5. Accepting the payment of a **fee**

Since the factors 1 - 3 above are essential to both franchise and license agreements, whether or not your license agreement "crosses the line" into franchise territory, boils down to evaluating control and fees. So:

- ◯ **WILL YOU POSSESS CONTROL OVER YOUR LICENSEE'S METHODS OF OPERATION?**
- ◯ **ARE YOU OBLIGATED TO PROVIDE SUPPORT TO YOUR LICENSEE'S OPERATIONS?**
- ◯ **WILL YOU RECEIVE OR BE OWED A FEE AS A CONDITION FOR YOUR LICENSEE TO COMMENCE ITS OPERATIONS?**

If your answers are YES then proceed with caution. Carefully consider this reality: Your business relationship constitutes a "Franchise".

TAKE A STEP BACK.

UNDERSTAND LICENSING

IS A COMPONENT TO

FRANCHISING

WHAT IS THE DIFFERENCE BETWEEN LICENSING AND FRANCHISING

EVERY FRANCHISE INCLUDES A LICENSE BUT **NOT EVERY LICENSE IS A FRANCHISE**

Traditionally, licensing is limited to a someone granting a license. This license allows a third-party licensee the right to use the licensee'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 franchisors trademarks and systems. Below are elements that legally converts a license into a franchise (thereby subjecting the "licensor" to franchise regulation), including:

- **INITIAL FEE PAYMENT—NO MATTER WHAT YOU CALL IT (I.E., FRANCHISE FEE, LICENSE FEE, TRAINING FEE OR CONSULTING FEE).**
- **ROYALTY OR A RECURRING FEE OBLIGATION. KEEP IN MIND THAT, SOMETIMES, CONSISTENT PRODUCT OR SERVICE PURCHASES MAY BE VIEWED AS A ROYALTY.**
- **CONTROL OVER ADVERTISING PROGRAMS.**
- **CONTROL OVER FRANCHISEE OPERATIONS.**

WHY YOU NEED TO PROCEED WITH 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. Ensure that the proper restrictions are in place and that you do not cross the line into franchise territory. Many times, if not most, you'll be much better off by just structuring a franchise instead.

BENEFITS TO FRANCHISING

By establishing a franchise (once the heavy lifting is done, i.e., getting your FDD prepared and Franchise Agreement in place) 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 developing and expanding your business and systems.

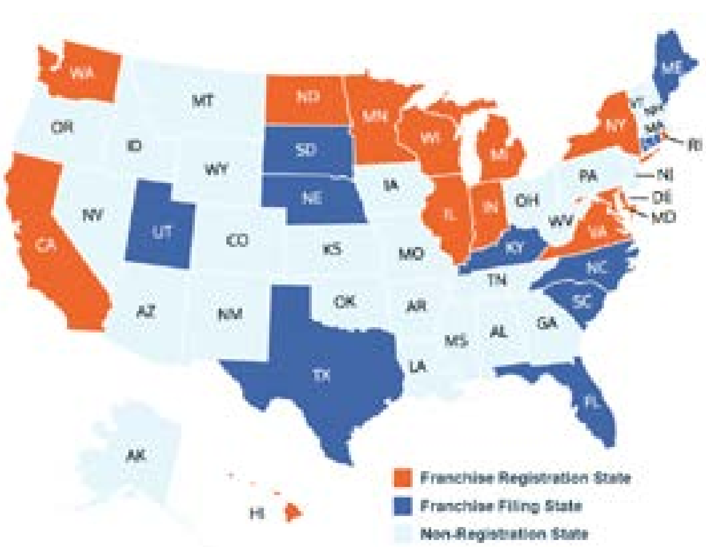
IS YOUR LICENSE AGREEMENT A FRANCHISE?

If you have licensed certain aspects of your business (*i.e.*, where others have opened their own locations using your products, services, trade dress and, possibly trademarks) then you may actually 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.

ASK YOURSELF THESE 3 QUESTIONS:

To better assess whether or not your license relationship is actually a franchise, consider these 3 questions:

- IS THE LICENSEE'S RIGHT TO MY BUSINESS ASSOCIATED WITH OR IDENTIFIED BY MY BUSINESS NAME, TRADEMARK, OR OTHER COMMERCIAL SYMBOL?
- IS MY LICENSEE REQUIRED TO MAKE PAYMENTS TO MY BUSINESS?
- 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 **www.franchiseregistrationstates.com**.

WHEN YOUR LICENSE AGREEMENT VIOLATES THE FRANCHISE LAWS

Surprisingly, far too often clients present me with license agreements that, many times, are nothing other than a disguised franchise agreement. This includes clients who previously sold a license and is now presented with a claim that he or she unlawfully sold a franchise.

FRANCHISE AGREEMENTS VS. LICENSE AGREEMENTS

Other than using the word "license" instead of "franchise", these agreements are every bit of a franchise agreement. What's 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).

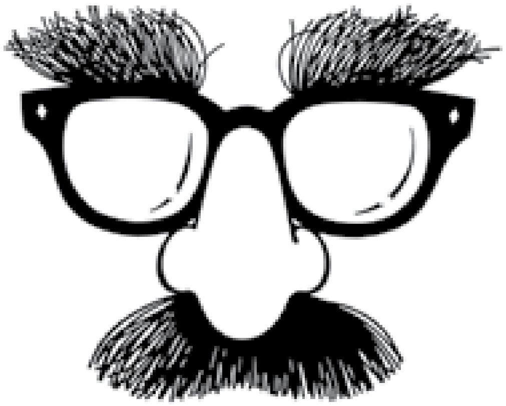
"Licensee agrees that in the event that Licensor applies to become a Franchisor… Licensee shall assist, by any reasonable means, Licensor in becoming franchisor… and in converting Licensee's licensed units into franchised units…"

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

1. The conversion provision in the license agreement 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 bad situation.

BLATANT FRANCHISE VIOLATIONS: FRANCHISE AGREEMENTS DISGUISED AS LICENSE AGREEMENTS

FRANCHISE AGREEMENTS DISGUISED AS LICENSE AGREEMENTS



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 disregard of the franchise laws and regulations. There are extremely successful and well intentioned business owners who have expanded their brand through license agreements but 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. These license agreements:

- **ESTABLISH A CONTINUING COMMERCIAL RELATIONSHIP.**
- **GRANT A LICENSE TO USE CERTAIN TRADEMARKS AND INTELLECTUAL PROPERTY.**
- **PERMIT THE LICENSOR TO HAVE A SIGNIFICANT AMOUNT OF CONTROL OVER THE LICENSEE'S OPERATIONS SUCH AS ALL GOODS AND PRODUCTS MUST BE PURCHASED FROM THE LICENSOR AND THE LICENSEE MUST CONFORM TO CERTAIN STANDARDS FOR OPERATION.**
- **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 roadmap that would lead a regulator to absolutely conclude that a franchise relationship has been established, they actually take it a step further. They 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".

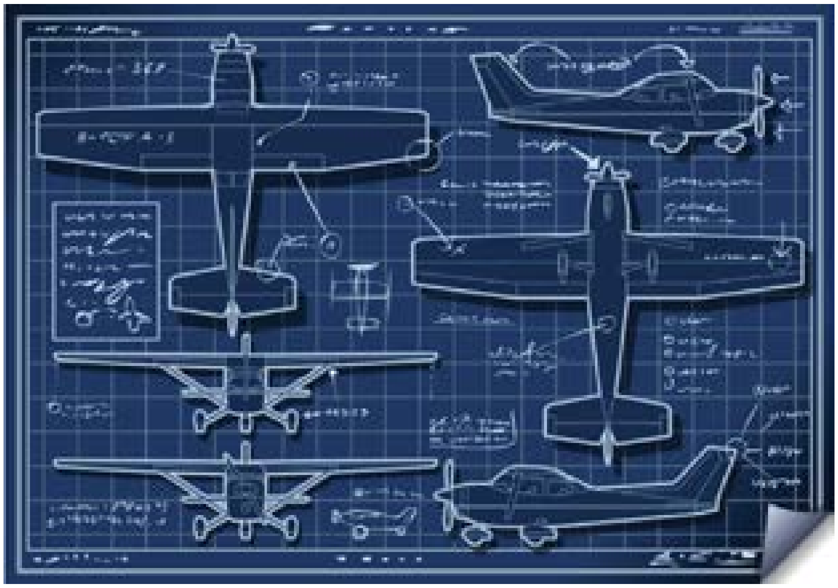
Judging by the number of proposed "license agreements" that I have seen recently, I question and ask you to question the following:

- Are lawyers actually drafting these license agreements? If so, do their clients really understand the significant exposure that they may be subjecting themselves to in the future? For example, what happens 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, in almost all situations, you will be required to satisfy the franchise laws and regulations.
- If you are looking to disguise a franchise as a license due to a lack of capital, the money that you're saving upfront is not worth the future litigation cost. What's worse is when you do eventually decide to franchise your business the right way,

OUR 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 ways to achieve 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, 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 your assets and to legally systematize, protect and license (yes, I have used the word “license”) these assets so that franchisees can duplicate your business.

WHAT ARE THE ADVANTAGES OF FRANCHISING?

1. MULTI-UNIT EXPANSION

Franchising is a vehicle for growth and expansion. Franchisors benefit from the expansion of their business through the efforts of franchisees.

2. 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.

3. MANAGERIAL TALENT

Business expansion requires dedicated managerial talent. Assuming that you choose your franchisees wisely, a benefit of franchising is that dedicated operators will manage their franchised locations and also have a vested equity interest in the business.

4. ADDITIONAL REVENUE SOURCES

As a franchisor—depending on how your franchise agreements are structured—you will receive additional income streams in the form of ongoing 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.

5. 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'S NEXT FOR YOUR BUSINESS? IS FRANCHISING RIGHT FOR YOU?

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 franchise sales constituting more than 33% of all United States retail sales, the significance of franchising has led successful business owners and entrepreneurs to the following question: "Is franchising right for my business?" There is no easy answer the right decision requires a thorough assessment of your business, your management skills and the business systems and assets that you have established.

Full Disclaimer: Franchising is not right for every successful business, if you are interested in franchising your business, below are four questions that you should evaluate and answer.

Answering these questions are not easy and require serious consideration. Think about the direction that your business is going in. How committed are you to create a franchise system and infrastructure that will provide franchisees with the ability to duplication your business and success.

If you are a successful business owner and entrepreneur, chances are that you have thought about expanding your business through franchising. It would allow you to take the trademarks, services, and business systems that you have created and license them to third-party franchisees. The franchisees would then devote their own time and capital into expanding your business concept and, hopefully, benefit from the experience and success that you have achieved. No doubt, franchising is a popular and extraordinary vehicle (when done correctly) to achieve the multi-unit expansion of a business. However, franchising is not right for every business or entrepreneur.

4 QUESTIONS TO ANSWER BEFORE YOU START A FRANCHISE

1. DO YOU HAVE BUSINESS SYSTEMS?

Franchising is all about duplication, consistency and uniformity. That is, are franchisees able to recreate the unique qualities and customer experience that has made your business a success?

To recreate this success 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
(f) administration

These systems will vary from business to business. The good thing is that 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. Keep in mind that you must be able to quantify these systems, write them down, simplify them, and teach them to your future franchisees.

2. CAN YOUR SYSTEMS BE TAUGHT TO FRANCHISEES?

Once you have identified your systems, the next question is whether or not your systems can 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.

List some of your most important business systems and which ones you believe can be taught to franchisees and executed properly:

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, make sure that your trademarks are unique to your business and are capable of obtaining legal protection. How do you do that? Your trademark cannot be a generic term, be a name that is currently used by others, and must be capable of registration with the United States Patent and Trademark Office.

Not sure if your brand name is protectable? Call us at (800) 976-4904 for a complimentary consultation and we'll point you in the right direction.

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. Before you franchise, you must first ensure that your business has a consistent track record of profitability and growth. Also, you'll have to evaluate if your franchisees will have profitable growth if they follow your systems. When making this profitability analysis, unlike your own business, you must take into account:

- **THE ROYALTIES THAT THE FRANCHISEE WILL BE PAYING TO YOU ON A WEEKLY OR MONTHLY BASIS**
- **THE FACT THAT THE FRANCHISEE MAY HAVE HIGHER OPERATING COSTS THAN YOUR ESTABLISHED BUSINESS**
- **THE FRANCHISEE MAY BE SERVICING DEBT OBLIGATIONS USED TO ESTABLISH ITS BUSINESS**

Before franchising, consider the following opening costs for franchisees:

Leasehold Improvements: ____

Construction:____

Furniture, Fixtures, and Equipment: ______________________________________

Signage: ____

Computer, Software, Point of Sales System: __________________________________

Initial Inventory: ____

Prepaid Rent and Lease Deposits: ____

Grand Opening Marketing Expenses: _____________________________________

Additional Funds: ____

RECAP

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, remember this:

1. The quicker you act, the better off you will be.

2. Before taking any action, speak to your franchise lawyer. Establishing a clear plan to convert your franchises, create your FDD and compliance documents, and correct your prior action with state regulators.

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.

WANT TO CONVERT YOUR LICENSE TO A FRANCHISE?

We would be glad to help! **Call us at (800) 976-4904** to set up a free call with Charles N. Internicola, Esq. for an honest assessment about if your license is a franchise and how we can help you grow your brand the right way.

ABOUT

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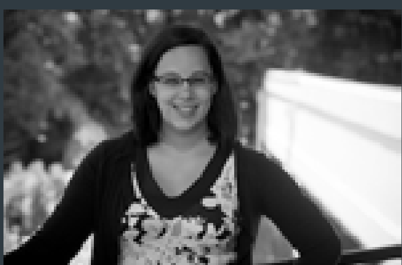

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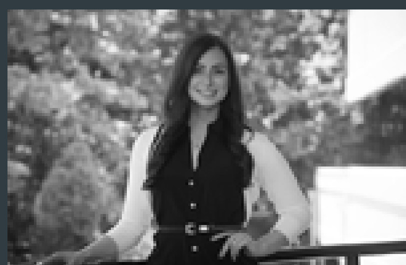

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At The Internicola Law Firm, P.C., we represent emerging brands, we help them grow, and we help them build industry leading franchise systems.

We are a law firm with the heart of an entrepreneur. We're business owners and franchisors, too. Our team is obsessed with seeing emerging brands win in the marketplace and win with franchising. We combine our legal expertise with winning franchise industry know-how to give you an advantage in the market.