GROWTH STRATEGIES: INCLUDING FRANCHISING, LICENSING, AND DISTRIBUTION

There are many ways in which a business can structure growth. Some examples include: (a) adding additional company-owned outlets; (b) mergers and acquisitions; (c) appointing distributors or dealers; (d) licensing; (e) partnerships and joint ventures; and (f) franchising. Each growth strategy has its own advantages and disadvantages, and each has its own legal ramifications. This article will explore different growth strategies with a particular emphasis on franchising, which is the most highly regulated of the growth strategies analyzed. The broad scope of the franchise laws may apply to a distributorship or license relationship resulting in an unwitting breach by a business owner of Federal or state franchise and business opportunity laws. The purpose of this article is to make the business owner and their advisors aware of the scope of the franchise and business opportunity laws and how they may affect the growth strategy sought to be employed by the business owner.

The following is a general description of the various growth strategies, including the advantages and disadvantages to each:

1. **Company-Owned Outlets**. A business may increase growth by building additional outlets regionally, nationally, or internationally. Depending upon the nature of the business, this could mean adding additional retail locations, additional manufacturing facilities, additional sales offices, additional distribution facilities, etc. The advantages to this method of expansion are: (a) the company retains complete control and flexibility over the expansion process, including timing, management decisions, employment decisions, policies and procedures, resale prices, and customers; and (b) the company retains all profits from such expansion. The disadvantages are: (a) such expansion may require significant capital expense; (b) the company assumes all risks of loss if any one or more of the additional outlets are not successful; (c) the company's managers may not have the same incentive or motivation as a distributor, licensee or franchisee; (d) potential liability for the actions of the company's managers and other employees; (e) the company has additional employment related expenses and liability exposure (payroll taxes, benefits programs, labor problems, employment law issues); and (f) multiple state tax and business license expenses.
2. **Acquisitions**. A business may grow by acquiring other companies in the same or similar business. The primary advantages to this method of expansion are the control and flexibility on the timing, and the ability to increase growth exponentially in a very short period of time. However, there are some serious disadvantages to this type of growth, including: (a) the high cost of acquiring companies, often at a premium price; (b) the legal and accounting expense in the due diligence process; (c) the potential liabilities of the acquired company; (d) the potential difficulty in merging the cultures and personnel of two different companies; and (e) the potentially adverse effect the acquisition may have on the customers of the acquired company.

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3. **Distributorships/Dealerships**. A business may increase growth by appointing distributors or dealers to sell or distribute its goods or services. Distributors typically purchase product directly from a manufacturer, take title to the merchandise, and re-sell the products at such prices as the distributor determines. Distributors may or may not be granted exclusive territories within which to distribute the manufacturer's products. Dealerships are similar to distributorships, but a Dealer typically purchases products from a Distributor, rather than directly from the manufacturer, and Dealers typically sell products at retail to the end user, as opposed to Distributors who typically sell product at wholesale to Dealers. In practice, the terms Distributor and Dealer are sometimes used interchangeably. Some of the advantages of a distributorship or dealership include: (a) lower capital expense by the manufacturer than adding company-owned outlets; (b) the Distributor/Dealer assumes the risk of loss upon purchase of the product from the Manufacturer; (c) the Distributor/Dealer becomes the responsible employer for its own employees; (d) the Distributor/Dealer pays its own state and local business taxes; (e) advertising expenses are incurred by the Distributor/Dealer, or at least shared with the manufacturer; and (f) risk of failure is shifted primarily to the Distributor/Dealer. Some of the disadvantages of a distributorship or dealership include: (a) loss of control over the sales process; (b) lower margins; (c) potential dilution of trademark if products are sold in conjunction with Distributor/Dealer's trademark; and (d) the Distributor/Dealer may be selling a competitor's product.

There are very subtle differences between a Distributor/Dealer relationship and a franchise relationship, and there are numerous instances where a purported Distributor/Dealer has been deemed to be a franchise. This often results in significant liability to the company if they have not complied with the franchise disclosure laws. Each Distributor/Dealer relationship should be carefully reviewed to confirm that it is not deemed to be a franchise. Laws regulating Distributorships and Dealerships (where they exist), are generally more lenient than laws regulating franchising or independent sales representatives.

4. **Independent Sales Representatives**. Independent Sales Representative relationships are closely related to distributorships and dealerships. But, unlike a distributor or dealer, an Independent Sales Representative does not purchase products for resale at a profit. Rather, an Independent Sales Representative solicits orders for products or services on behalf of the company and is usually compensated in the form of a commission. The advantages of Independent Sales Representative are similar to those associated with distributorships and dealerships, but with greater control over pricing and less risk of competition (Independent Sales Representatives are usually prohibited from selling competing products, whereas Distributors and Dealers are usually not so prohibited). The Independent Sales Representative relationship has greater financial and legal risk than the distributorship or dealership relationship. Finally, one must be careful to structure the Independent Sales Representative relationship to avoid liability as an employer (including withholding tax liability, unemployment compensation and workers compensation insurance). Many states now have laws regulating the relationship between independent sales representatives and the suppliers of the products and services for which orders are solicited.

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5. **Technology and Know-how Licensing**. In a traditional technology or know-how license relationship, the licensor possesses technology that is the subject of one or more patents or technology or know-how that includes one or more trade secrets (Intellectual Property). The licensor permits the licensee to manufacture, use and/or sell products or use processes that are within the scope of its Intellectual Property. Provided the licensee is not permitted to use any trademark or other advertising symbol of the licensor, the arrangement will fall outside the definition of a franchise. The licensee in these arrangements are typically already actively engaged in business at the time of creation of the relationship, and the licensor does not significantly control or assist the licensee in the conduct of its business. An example of a technology or know-how license would be a relationship between an independent product designer and a manufacturer wherein the designer permits the manufacturer to manufacture and sell a new product created by the designer. The primary advantage of this type of arrangement to the owner of the Intellectual Property is the opportunity for the owner of the technology to receive income without significant effort, investment or risk. The primary disadvantages to this type of relationship include little or no control, and the inability of the owner of the technology to obtain the benefit of the goodwill created by the licensee's business activities. Where the licensee is expressly prohibited from using any trademark or other identifying symbol associated with the licensor, no franchise law issues arise. However, if the relationship includes the use of any such trademark or other identifying symbol, the elements of a franchise should be considered.
6. **Trademark License**. In a "pure" trademark license, a licensor grants a single license to one licensee to enable the licensee to manufacture a product according to the licensor's specifications, and to sell such product under the licensor's trademark. Another form of trademark license is a "collateral product" license, where a licensee is granted the right to use a trademark that is well known in one context in an entirely different context. This is also known as "merchandising". The primary advantages to the licensor of these "pure" licenses include: (a) the opportunity for the licensor to receive income without significant investment or financial risk; and (b) the creation of substantial goodwill in the trademark. The disadvantages include loss of control, including the risk that the licensee's poor quality or sales performance may tarnish the reputation of the licensor. While a pure trademark license is not usually covered by franchise and business opportunity laws, since every franchise relationship includes a trademark license, it would be prudent to consider the elements of franchise and business opportunity laws when structuring or terminating any trademark license relationship.
7. **Partnerships and Joint Ventures**. A partnership exists when two or more persons or entities associate to carry on a business for profit as co-owners. Partnerships may be structured as general partnerships or limited partnerships depending on the participation and liability of the parties. The advantages of a partnership or joint venture include: (a) greater control than a Distributorship/Dealership, licensing arrangement or franchise; (b) sharing of profits in accordance with the partnership agreement; (c) flexibility in structuring the relationship and growing the business; and (d) few regulatory issues. The

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primary disadvantages include all of those associated with Company-Owned Outlets, as well as the potential for partnership disputes. A general partnership is not covered by the Federal franchise law. However, a limited partnership may be covered by the Federal franchise law, and the elements of a franchise and business opportunity under both Federal and state law should be considered when structuring or terminating limited partnership relationships.

8. **Franchising**. A business may also grow through franchising. There are two distinct types of franchises – package franchises and product franchises. A package franchise exists when a franchisor licenses a franchisee to do business under a pre-packaged business format established by the franchisor and identified with the franchisor's trademark. The franchisor usually provides the franchisee with initial training and assistance in the establishment of the franchised business as well as some ongoing assistance. The franchisor usually exerts significant control over the method in which the franchisee operates its business. McDonalds® and Burger King® are good examples of package franchises. Product franchises, on the other hand, exist where the franchisor has already produced goods and the franchisee merely provides an outlet for the goods. The franchisor will usually exercise significant control over the franchisee's operation to ensure proper marketing of the product. Gas stations and car dealerships are examples of product franchises. The primary advantages of a franchise relationship include: (a) lower capital expense than company-owned outlets; (b) most of the risk is absorbed by the franchisee; (c) the franchisee becomes the responsible employer; (d) the franchisee is responsible for state and local taxes and business licenses; and (e) the franchisee will generally have a greater interest in the success of the business than a manager of a company-owned outlet. Since franchisors generally exert a significant degree of control on the franchisee's method of operation, there is more control in a franchise relationship than in a distributorship/dealership or license. Furthermore, since the franchisee operates its business under the franchisor's trademark, most of the goodwill of the franchisee's business inures to the benefit of the franchisor. The primary disadvantages of a franchise relationship are the additional regulatory (and legal) expense, and the additional level of administration to manage the franchise process (including sales, training, operations, etc.).

As you can see, there are many ways in which a business can structure its growth. No one method is better than another. A prudent business owner will analyze each of the options listed above to determine which method of expansion is appropriate for the type of business and business structure desired by the business owner. Obviously, franchising has become a very popular and successful method of business expansion. The following is more detailed description of the laws that regulate franchising, how to comply with such laws, and how to avoid becoming an inadvertent franchisor:

Franchising and business opportunities are regulated at both the state and Federal level. Under Federal law, franchises and business opportunities are regulated pursuant to 16 C.F.R. Part 436 (1978) – the "Franchise Rule", and the guidelines, statements and opinions rendered thereunder. What constitutes a franchise or business opportunity under

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Federal law is somewhat different then under the various state statutes that regulate franchise and business opportunity laws. The package franchise and the product franchise are described above. In a business opportunity, the business opportunity seller (the "Seller") distributes, in accordance with a system established by the Seller goods or services that do <u>not</u> bear the Seller's trademark. Often, the Seller promises to secure retail outlets or accounts for the Buyer to sell the goods or services. Examples of business opportunity ventures include rack jobbing and vending machine routes. In rack jobbing, a Seller sells goods to the Buyer, and obtains retail stores to carry the goods. The rack jobber merely orders inventory from the Seller and stocks the racks. In vending machine routes, the Seller sells machines to the Buyer and obtains locations for the machines. The Buyer orders inventory (often from 3rd parties) and keeps the machines stocked. In giving this type of assistance, the Seller reduces the Buyer's risk of starting its own business by establishing both a supply of goods and a location or outlet for their sale. In essence, the Seller gives the Buyer a prepackaged business.

The definition of a franchise under the Franchise Rule has three basic elements. If the growth strategy includes all three elements, regardless of the name given to the relationship or the intent of the parties, the relationship will be deemed a franchise. The three elements are: (1) the licensing or association of the franchisee's business with the franchisor's trademark or trade name; (2) the payment of a fee or other compensation (generally, in excess of $500.00 prior to or within the first 6 months of operation by the franchisee); and (3) significant assistance by the franchisor, or the exertion or right to exert significant control over the franchisee's business by the franchisor. If the relationship is structured to avoid any one of the three elements, the relationship will not be a franchise under Federal law (but may be a franchise or business opportunity under state law). For example, if the franchisee is not permitted to use the franchisor's trademarks, and is not authorized to associate its business with the franchisor's trademark, the relationship will not be a franchise under the Franchise Rule.

Beware that the fee element under the Franchise Rule is broadly construed, and can include all forms of direct and indirect payments to the franchisor. Excluded from the definition of a franchise fee are reasonable amounts of inventory sold to the franchisee at bona fide wholesale prices for resale by the franchisee. An extreme example of the broad definition of a franchise fee is the case <u>To-Am Equipment Co. vs. Mitsubishi Caterpillar Forklift America, Inc.</u>, in which a franchise fee under Illinois law was found to exist where the Caterpillar distributor was required to spend approximately $1,500.00 for manuals over the course of several years (the Illinois law does not have the 6-month limitation that is contained in the Franchise Rule). Although the parties never intended to create a franchise relationship, a multi-billion dollar, international company like Mitsubishi became an inadvertent franchisor. Under Illinois law, the franchisor was not permitted to terminate the franchise relationship without good cause.

Significant control refers to the degree of the control the franchisor has over the franchisee's business organization, management, marketing plan, promotional activities or business affairs. Examples of significant types of control over the franchisee's method of operation are as follows: site approval for new business locations; site design or

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appearance requirements; hours of operation; production techniques; accounting practices; personnel policies and practices; promotional campaigns requiring franchisee participation or financial contribution; restrictions on customers; and location or sales area restrictions.

Significant assistance means that the franchisee is substantially dependent on the franchisor's assistance in the overall operation of the franchisee's business. Examples of significant assistance may include: formal sales, repair or business training programs; establishing accounting systems; furnishing management, marketing or personnel advice; selecting site locations; and furnishing a detailed operating manual. Assistance solely in the franchisee's promotional activities, in the absence of assistance in other areas, does not constitute significant assistance.

The definition of a business opportunity under the Franchise Rule includes the following three elements: (1) the payment of a fee or other compensation (same definition as for a franchise); (2) the requirement that the franchisee must sell goods or services supplied by the franchisor, by the franchisor's affiliate, or by suppliers designated by the franchisor; and (3) the franchisor or its designee supplies the franchisee with retail accounts or outlets for the goods or services, or obtains locations for vending machines or racks.

Finally, the Franchise Rule provides some specific exemptions and exclusions as to what constitutes a franchise under the Franchise Rule, including: oral agreements, fractional franchises, leased departments, employment relationships, general partnerships, cooperatives, certification or testing services, and single trademark licenses.

If a business relationship meets the definition of a franchise or business opportunity under the Franchise Rule, the franchisor must comply with the disclosure requirements of the Franchise Rule (there is no registration requirement under federal law), and the other provisions of the Franchise Rule (no false or misleading statements, etc.). Disclosure comes in one of two formats – the seldom-used FTC format, or the Uniform Franchise Offering Circular (UFOC). The UFOC consists of 23 separate items of disclosure, in a prescribed format. The disclosure document includes information regarding the franchisor, the investment by the franchisee, the general rights and obligations of the franchisor and franchisee under the franchise agreement, the franchisor's audited financial statements, the name, address and phone number of the other franchisees in the system, etc. The disclosure document must be delivered to the prospective franchisee at the earlier of (a) the first personal meeting between the franchisor and franchisee involving a discussion of the franchise opportunity; (b) at least 10 business days before the franchisee signs any agreement with the franchisor; or (c) at least 10 business days before the franchisee pays any money to the franchisor.

In addition to the Franchise Rule, many states regulate franchises and business opportunities, and the definition of what constitutes a franchise or business opportunity varies from state to state. The two most common definitions are often referred to as the "Marketing Plan or System" definition, and the "Community of Interest" definition.

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The Marketing Plan or System definition generally consists of three elements: (1) the franchisee's business is substantially associated with the franchisor's trademark (merely selling products bearing the franchisor's trademark will not generally constitute the presence of this element); (2) the franchisor grants the franchisee the right to offer, sell or distribute goods or services under a marketing plan or system prescribed in substantial part by the franchisor (many factors determine whether this element is present, including the initial and ongoing assistance and control exercised by the franchisor); and (3) the franchisee is required to pay to the franchisor, directly or indirectly, a fee (as described above, the fee element may be very broadly defined). At least 12 states employ this type of definition: California, Connecticut (element of franchise fee not required), Illinois, Indiana, Maryland, Michigan, New Jersey, North Dakota, Oregon, Rhode Island, Virginia (element of franchise fee not required) and Wisconsin.

The Community of Interest Definition generally consists of three elements: (1) use by the franchisee of the franchisor's trademark (not necessarily substantial association as with the Marketing Plan or System definition); (2) the franchisor and franchisee have a common financial interest in the franchisee's business (this may exist where the franchisee buys its inventory from the franchisor to resell it in the ordinary course of its business); and (3) the franchisee is required to pay to the franchisor, directly or indirectly, a franchise fee. At least 8 states employ this type of definition: Hawaii, Minnesota, Mississippi, Missouri (element of franchise fee not required), Nebraska, New Jersey (element of franchise fee not required), South Dakota and Washington (and the District of Columbia).

Other states have other definitions, and many states have exemptions and exclusions similar to those under the Franchise Rule.

The state franchise laws regulate franchising in several respects: registration requirements, filing/disclosure requirements, and substantive relationship laws.

Approximately 14 states require registration of the franchisor's offering circular before the franchisor can begin offering franchises in that state, or to residents of that state – California, Hawaii (no formal review process), Illinois, Indiana (no formal review process), Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. As a general rule, the UFOC is approved by all registration states with some relatively minor variations that can be covered in an Addendum to the UFOC and franchise agreement.

Some states merely require the filing of a notice with the state regulatory authority prior to offering franchises for sale in that state, and require the delivery of an offering circular to the prospective franchisee prior to the sale of the franchise.

Finally, some states have laws that regulate the relationship between a franchisor and franchisee. An example of a relationship law is where a franchisor is prohibited from refusing to renew a franchisee's franchise agreement without good cause. The following states have substantive franchise relationship laws: Arkansas, California, Connecticut,

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Delaware, Hawaii, Illinois, Indian, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, South Dakota, Virginia, Washington and Wisconsin (and the District of Columbia).

In addition to the state franchise laws, approximately 23 states have Business Opportunity Laws: California, Connecticut, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia and Washington. Business opportunity laws regulate various business relationships, whether they are distributorships, dealerships, or some other form of business relationship. Many state business opportunity laws exempt franchise relationships from their coverage. The elements of a business opportunity under most state business opportunity laws include: (1) the sale or lease of products allowing the buyer to start a business; and (2) the seller makes certain representations or guarantees with respect to profits, buy-back obligations, refunds or sales or marketing assistance. Some definitions include a fee element.

Many state business opportunity laws provide an exemption where the sale or lease is made in conjunction with the licensing of a registered trademark. Because the state business opportunity laws are not uniform (and vary to a greater extent than the state franchise laws), a relationship must be analyzed under each state business opportunity law in which the relationship may exist.

Finally, in addition to franchise and business opportunity laws, there are other laws that regulate certain types of relationships and certain industries. For example, there is the Automobile Dealer Franchise Act which regulates the relationship between automobile manufacturers and their dealers, the Petroleum Marketing Practices Act which regulates relationships in the chain of distribution of motor fuel, and various state laws that govern liquor, beer and wine distributorships. It is always advisable to research state industry laws before structuring, establishing or terminating any business relationship.

In conclusion, while there are many ways in which a business can grow, a prudent business owner will explore each growth strategy, analyzing the advantages and disadvantages as they relate to that particular type of business and the goals of the business owner. It is imperative that the growth strategy be structured so that it does not violate franchise, business opportunity, or other laws that regulate the relationship of the parties. There are numerous instances in which a business owner has inadvertently violated the franchise laws because of the way a particular relationship was structured. The violation of the franchise laws can have severe consequences, including, in some cases, the right of the franchisee to rescind the transaction, the right of the franchisee to sue for damages, and the assessment of civil and criminal penalties against the franchisor and its principals.

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