FRANCHISE ISSUES IN PRODUCT DISTRIBUTION SYSTEMS

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ABA Forum On Franchising
Dallas, Texas
October, 1993

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Introduction

Companies with traditional product distribution systems face unusual legal and practical business challenges when they convert dealerships or employee sales force to regulated "Product Franchise" relationships. Similar legal questions arise when a product distributor incorporates "combination franchising" programs into their distribution structure. In an important sense, franchise law, particularly state law, was not designed to regulate product distribution systems or easily answer the legal questions that arise in a conversion or combination franchising program. Designed for classic business format franchise systems, franchise law is often ill equipped to accommodate these business situations.

I. Product Franchising Overview

Federal Regulation of Product Franchising

The FTC Rule Interpretive Guides define a product franchise as follows:

> A product franchise distributes goods that are produced by the franchisor (or under his control or direction) and which bear the franchisor's trademark. The product franchisor exercises significant control over the franchisee's method of operation or, alternatively, promises to provide a significant degree of assistance in the franchisee's method of operation. The franchisee is required to pay the franchisor for the right to sell the trademarked goods, either by required purchases of equipment, supplies, etc., or by paying an initial fee for the right to sell the goods. (See CCH Business Franchise Guide, ¶6204).

The definition of a product franchise is particularly important in conversion programs. The presence or absence of the elements of the FTC Rule's definitions and comparable definitions under state law will dictate the regulatory consequences of the conversion. Traditionally, dealership arrangements where there is no trademark license, no involvement with the dealer's business operation, or no payment of an identifiable franchise fee are not considered subject to franchise regulation. Dealerships in the petroleum industry, the automobile industry, and the farm equipment industry, have not been regulated as "product franchises" under the FTC Rule or under state franchise investment laws because of the absence of one or more of these definition elements.

One important element of the FTC Rule's definition of a franchise is the "required payment," directly or indirectly, to the franchisor of an amount that exceeds $500 in the first 6 months of the franchisee's business operation. The Commission addressed this subject in its Interpretive Guides:

> The Commission's objective in interpreting the term "required payment" is to capture all sources of revenue which the franchisee must pay to the franchisor or its affiliate for the right to associate with the franchisor and market its goods or services. Often, required payments are not limited to a simple franchise fee, but entails (sic) other payments which the franchisee is required to pay to the franchisor or an affiliate, either by contract or by practical necessity. Among the forms of required payments include initial franchise fees as well as those for rent, advertising assistance, required equipment and supplies -- including those from third parties where the franchisor or its affiliate receives payment as a result of such purchases -- training, security deposits, escrow deposits, non-refundable bookkeeping charges, promotional literature, payments for services of persons to be established in business, equipment rental, and continuing royalties on sales. (CCH Business Franchise Guide ¶6207).

The Rule, of course, excludes from the concept of a required payment certain payments for start up inventory. It is a narrowly drawn concession to the realities of the marketplace:

> Questions have been raised as to where, within the foregoing scheme, fall payments for inventory sold at a bona fide wholesale price. The Commission recognizes that it is, as a practical matter, virtually impossible to draw a clear line between start-up inventory that is purchased at the franchisee's option, and that which is purchased as a matter of practical or contractual necessity. In order to minimize ambiguity in this respect, but consistent with the Commission's objective that "required payment" capture all sources of hidden fees, the Commission will not construe as "required payments" any payment made by a person at a bona fide wholesale price for reasonable amounts of merchandise to be used for resale. The Commission will construe "reasonable amounts" to mean amounts not in excess of those which a reasonable businessman normally would purchase by way of a starting inventory or supply or to maintain a going inventory or supply. (CCH Business Franchise Guide, ¶6207).

Of equal importance is the Rule's broad requirement the a licensed trademark be present to constitute a franchise. The Interpretive Guides make it clear that the mere identification of the product that is subject to the franchise will suffice. The franchisee need not receive a license to use the franchisor's trademark to identify his business to the public.

> This element will be satisfied only when the franchisee is given the right to distribute goods and services which bear the franchisor's trademark, service mark, trade name, advertising or other commercial symbol ("the mark"). The most common instances occur when either the goods or services being distributed by the franchisee are associated with the franchisor's mark or when (i) the franchisee must conform to quality standards established by the franchisor with respect to the goods or services being distributed, and (ii) the franchisee operates under a name that includes, in whole or in part, the franchisor's mark.
>
> The Commission does not intend to cover package or product franchises in which no mark is involved. If a mark is not necessary to a particular distribution arrangement, the supplier may avoid coverage under the rule by expressly prohibiting the use of its mark by the distributor. (CCH Business Franchise Guide, ¶6205).

Most product distribution programs feature the distribution of product identified by a trademark and easily meet this definition before a franchise conversion takes place. State franchise investment law definitions are not as broad as the FTC Rule on the point of trademark licensing. Most of them require the licensed business to operate under the franchisor's trademark.

The third element of the FTC Rule definition, "significant control" or "significant assistance" may or may not be pivotal in a conversion program:

> The term "significant" relates to the degree to which the franchisee is dependent upon the franchisor's superior business expertise -- an expertise made available to the franchisee by virtue of its association with the franchisor....
>
> Among the significant types of controls over the franchisee's method of operation are those involving a) site approval for unestablished businesses, b) site design or appearance requirements, c) hours of operation, d) production techniques, e) accounting practices, f) personnel policies and practices, g) promotional campaigns requiring franchisee participation or financial contribution, h) restrictions on customers, and i) location or sales area restrictions.
>
> Among the significant types of promises of assistance to the franchisee's method of operation are a) formal sales, repair or business training programs, b)

> establishing accounting systems, c) furnishing management, marketing or personnel advice, d) selecting site locations, and e) furnishing a detailed operating manual.... (CCH Business Franchise Guide, ¶6206)

The FTC Rule definitions will apply to dealer or employee conversion programs where all three of the elements are met. The consequence of meeting the definition is, of course full presale disclosure required nationally. Of equal concern to the company considering commencing a product franchise conversion is the uncertain application of state franchise investment laws, relationship laws, and business opportunity statutes.

Product Franchising In The States

State law regulating product franchising is much less precise than federal law, and the legal analysis must tackle several completely distinct bodies of law.

A number of cases in recent years have considered the dimensions of the franchise fee, community of interest, and trademark license aspects of the relationship law definitions. The courts have found few bright lines that the distribution community can rely on in its conversion or combination franchising plans.

The New Jersey Supreme Court recently caught the attention of the computer industry by ruling that a computer hardware reseller's agreement constituted a franchise for purposes of the New Jersey Franchise Practices Act. In Instructional Systems, Inc. v. Computer Curriculum Corp., CCH Business Franchise Guide, ¶10,119 (NJ SCt. 1992), the Court ruled that the reseller relationship met the trademark license and community of interest elements of the franchise termination/relationship law. Most interesting was the court's analysis of the trademark license issue. The relationship satisfied this definition even in the absence of a trademark license. The court carefully examined the use of the trademark by the dealer and concluded that its promotion of the name was sufficient to:

> create a reasonable belief on the part of the consuming public that there is a connection between the trade name licensor and licensee by which the licensor vouches, as it were, for the activity of the licensee in respect of the subject of [sic] trade name.

Id., at page 23,841, quoting from Neptune T.V. & Appliance Serv., Inc. v. Litton Sys., Inc., CCH Business Franchise Guide, ¶8023; 190 N.J. Super. 153, 160 (App.Div. 1983).

A California court found that the substantial association with a trademark element was met in Kim v. Servossnax, Inc., CCH Business Franchise Guide, ¶10,124 (Calif. Ct. App. 1992).

A similar result was reached in a federal court case under the New Jersey Franchise Practices Act, Cooper Distributing v. Amana Refrigeration, CCH Business Franchise Guide, ¶10,094 (D.N.J. 1992), where the court found sufficient facts present to meet the trademark and community of interest elements of that statute's definition.

In 1987 the 9th Circuit issued an opinion in Boat & Motor Mart v. Sea Ray Boats, Inc., CCH Business Franchise Guide ¶8846, 817 F2d 573 (9th Cir. 1987) that startled the manufacturing community, at least those portions of the community that were not regulated as product franchisors. The Court ruled that various expenses undertaken by a boat dealer in servicing a manufacturer's warranties, its extensive advertising, and its purchases of promotional materials constituted a "franchise fee" within the meaning of the California Franchise Relations Act. A number of friends of the court petitioned for a reconsideration of the court's ruling on this important point of franchise law and the court issued a second written opinion. The subsequent ruling found the question was moot in light of the conclusions reached and the court removed those controversial findings on the franchise fee analysis. Boat & Motor Mart v. Sea Ray Boats, Inc., 825 F2d 1285 (9th Cir. 1987).

A few years ago the 7th Circuit found that a photocopier distribution agreement appeared to meet the definition of a franchise under the Indiana Deceptive Franchise Practices Act. In Wright-Moore Corp. v. Ricoh Corp., CCH Business Franchise Guide, ¶9665 (7th Cir. 1990), the 7th Circuit found that trademark use (distribution of product covered by the trademark) and marketing plan (quotas, national territory, training) elements were met by the facts of the relationship. The court also suggested broadly that certain expenses undertaken by the dealer (excessive required inventory purchases and "firm-specific" technical product training) might meet the law's definition of a franchise fee, and were sufficient questions of fact that the matter should not be decided on Summary Judgment. The case was remanded for further proceedings, where the district court concluded that no fee was present. CCH Business Franchise Guide ¶10,020 (DC Ind. 1991). The 7th Circuit recently affirmed the finding on appeal. CCH Business Franchise Guide, ¶10,111 (7th Cir. 1992).

Other rulings have explored distribution system issues. A regulated franchise may exist where the inventory is deemed by a court to be "excessive" or the price charged exceeds a bona fide wholesale price (see two opinions issued by the Wisconsin authorities regarding the Wisconsin Franchise Investment Law at CCH Business Franchise Guide, ¶9911 and ¶9912).

Industry Specific Statutes

A number of industries enjoy their own industry-specific regulation. Industry-specific laws regulate business relationships in the beer, wine, liquor, farm equipment, marine equipment, petroleum, and automobile industries.

The Petroleum Marketing Practices Act ("PMPA"), 15 USC 2801, has since 1978 articulated a preemptive national standard of circumstances justifying the termination or non-renewal of a petroleum dealership. In a ruling of significant import to the industry, the

Federal Trade Commission in 1980 granted an exemption from its Franchise Rule for relationships subject to the PMPA. CCH Business Franchise Guide, ¶7539.

The Automobile Dealer's Day In Court Act, 15 USC 1221-1225, adopted by Congress in 1965 creates a private right of action for an automobile manufacturer's failure to act in good faith. Unlike the PMPA, the automobile dealer law was designed to be supplemented by state dealer protection laws.

Business Opportunity Laws To Boot

Distribution programs considering a franchise conversion program may also find themselves subject to federal or state business opportunity regulation. A full description of this area of the law is beyond the scope of this presentation. However, business opportunity laws have been adopted by the Federal Trade Commission and 24 states. They regulate by registration, pre-sale disclosure, and bonding all manner of programs that enable a purchaser to begin a business.

It is in this legal context that traditional distribution systems must weigh the legal consequences of a product franchise conversion or a combination franchising program.

II. Issues of Particular Concern to Product Franchise Systems

A. Customer Restrictions/Encroachment. Product franchisors tend to grant "territorial" rights that bear little resemblance to the classic geographic radius or political jurisdictions granted by most business format franchisors. Consequently the application of the various standards designed for business format programs will have a far different impact on product distribution systems.

At least three of the state relationship law provisions will have noteworthy application to a product distribution franchise:

1. Indiana; BFG ¶4140.01

Unlawful for franchise agreement to contain provision:

"(2) Allowing the franchisor to establish a franchisor-owned outlet engaged in a substantially identical business to that of the franchisee within the exclusive territory granted the franchisee by the franchise agreement; or, if no exclusive territory is designated, permitting the franchisor to compete unfairly with the franchisee within a reasonable area." (Emphasis added).

2. Hawaii; BFG ¶4110.01

It is an unfair or deceptive practice for a franchisor to:

"(E) Establish a similar business or to grant a franchise for the establishment of a similar business at a location within a geographical area specifically designated as the exclusive territory in a franchise previously granted to another franchisee in a currently effective agreement, except under the circumstances or conditions prescribed in such agreement. The fact that other franchisees or the franchisor may solicit business or sell goods or services to people residing in such geographical territory shall not constitute the establishment of a similar business within the exclusive territory."

3. Iowa; BFG ¶4150.06

"SEC. 523H.6. 1. Notwithstanding the terms, provisions, or conditions of an agreement or franchise, if a franchisor seeks to establish a new outlet, company-owned store, or carry-out store within an unreasonable proximity of an existing franchisee, the existing franchisee, at the option of the franchisor, shall have either a right of first refusal with respect to the proposed new outlet, company-owned store, or carry-out store or a right to compensation for market share diverted by the new outlet. For the purposes of this section, "unreasonable proximity" as applied to a food establishment franchisor or food service establishment franchisor, including outlets and carry-out stores as defined by section 137A.1, subsection 2, and section 137B.2, subsection 6, includes but is not limited to the shortest distance as measured by the following methods:

a. A three-mile radius, using a straight line measurement, from the center of an already existing franchise.

b. A circular radius, using a straight line measurement, from an existing franchise business which comprises a population of thirty thousand or greater.

2. With respect to a right of first refusal, the parties shall in good faith seek to establish a mutually agreeable price and terms. If the parties are unable to agree, each party shall appoint an independent appraiser. If the independent appraisers are unable to agree upon a price and terms, the independent appraisers shall name a third appraiser to determine the price and terms upon which the right of first refusal may be exercised. The determination of the independent appraiser shall be final and binding, and subject to judicial review under chapter 679A.

If two or more existing franchises are located within an unreasonable proximity to the proposed outlet, the closest franchisee shall have the first right of first refusal, and if declined, the right of first refusal shall pass to the next closest franchisee.

3. If the franchisor does not offer a right of first refusal, the franchisor shall compensate existing franchisees for market share diverted by the opening of the new outlet. If the franchisor and existing franchisees cannot agree upon the proper amount of such compensation, each party shall appoint an independent appraiser. If the independent appraisers are unable to agree, the independent appraisers shall appoint a third appraiser who shall establish the level of compensation. The determination of the independent appraiser shall be final and binding, and subject to judicial review under chapter 679A."

See IFA Code of Ethics, §7, which imposes a dozen "factors to be considered" by a franchisor before granting territorial rights. The factors assume the franchisor is granting a geographic territory surrounding a retail location..

See LaFalce proposed Legislation; H.R. 1316; Sec. 4, imposing encroachment standards on franchisors.

B. Required Purchases. This is perhaps the legal point of the greatest divergence between business format franchisors, who rarely require the purchase of product from themselves, and product franchisors, for whom the required purchase of product is the principal reason for the relationship with their franchisees.

State franchise laws impose a series of restrictions on purchasing requirements clearly designed exclusively for business format systems:

1. Indiana; BFG ¶4140.01

"Sec. 1. It is unlawful for any franchise agreement entered into between any franchisor and a franchisee who is either a resident of Indiana or a nonresident who will be operating a franchise in Indiana to contain any of the following provisions:

(1) Requiring goods, supplies, inventories, or services to be purchased exclusively from the franchisor or sources designated by the franchisor where such goods, supplies, inventories, or services of comparable quality are available from sources other than those designated by the franchisor. However, the publication by the franchisor of a list of approved suppliers of goods, supplies, inventories, or service or the requirement that such goods, supplies, inventories, or services comply with specifications and standards prescribed by the franchisor does not constitute designation of a source nor does a reasonable

right of the franchisor to disapprove a supplier constitute a designation. This subdivision does not apply to the principal goods, supplies, inventories, or services manufactured or trademarked by the franchisor." (Emphasis added).

2. Hawaii; BFG ¶4110.01

It is an unfair or deceptive practice for a franchisor to:

"(B) Require a franchisee to purchase or lease goods or services of the franchisor or from designated sources of supply unless such restrictive purchasing agreements are reasonably necessary for a lawful purpose justified on business grounds. Suppliers suggested or approved by a franchisor as meeting its standards and requirements shall not be deemed designated sources of supply."

3. Iowa; BFG ¶4150.12

"Sec. 523H.12. 1. Except as provided in subsection 2, a franchisor shall allow a franchisee to obtain equipment, fixtures, supplies, and services used in the establishment and operation of the franchised business from sources of the franchisee's choosing, provided that such goods and services meet standards as to their nature and quality promulgated by the franchisor.

2. Subsection 1 of this section does not apply to reasonable quantities of inventory goods or services including display and sample items, that the franchisor requires the franchisee to obtain from the franchisor or its affiliate, but only if the goods or services are central to the franchised business and either are actually manufactured or produced by the franchisor or its affiliate, or incorporate a trade secret owned by the franchisor or its affiliate."

4. Washington; BFG ¶4470.01

It is an unfair or deceptive practice to:

"(b) Require a franchise to purchase or lease goods or services of the franchisor or from approved sources of supply unless and to the extent that the franchisor satisfies the burden of proving that such restrictive purchasing agreements are reasonably necessary for a lawful purpose justified on business rounds, and do not substantially affect competition: *Provided,* That this provision shall not apply to the initial inventory of the franchise. In determining whether a requirement to purchase or lease goods or services constitutes an unfair or deceptive act or practice or an unfair method of competition the courts shall be guided by the decisions of the courts of the

United States interpreting and applying the anti-trust laws of the United States."

See IFA Code of Ethics, §8, which allows required purchases from franchisors only in a three circumstances: (1) in conjunction with a "turnkey business"; (2) where the products and services utilize the franchisor's "trade secrets or proprietary processes or ingredients"; and (3) where it is not practical to issue specifications or standards.

See LaFalce proposed legislation; H.R. 1316; Sec. 3.(b)(1), allowing required purchases for reasonable quantities of inventory where the "goods or services are integrally related to a trademark, trade name, trade secret or patent..."

C. Inventory Repurchase. Inventory repurchase requirements take on a special importance when the franchisor is the supplier of the franchisee's principal inventory:

1. Michigan; BFG ¶4220.01

•The following is void if contained in a franchise agreement:

"(d) A provision that permits a franchisor to refuse to renew a franchise without fairly compensating the franchisee by repurchase or other means for the fair market value at the time of expiration of the franchisee's inventory, supplies, equipment, fixtures, and furnishings. Personalized materials which have no value to the franchisor and inventory, supplies, equipment, fixtures, and furnishings not reasonably required in the conduct of the franchise business are not subject to compensation. This subsection applies only if: (i) The term of the franchise is less than 5 years and (ii) the franchisee is prohibited by the franchise or other agreement from continuing to conduct substantially the same business under another trademark, service mark, trade name, logotype, advertising, or other commercial symbol in the same area subsequent to the expiration of the franchise or the franchisee does not receive at least 6 months advance notice of franchisor's intent not to renew the franchise."

2. Maryland; BFG ¶4200.04

"Sec. 11-1304. (a) Except as provided in subsection (c) of this section, on cancellation or nonrenewal of an agreement by a grantor for any reason, including a distributor's failure to cure under § 11-1305 of this subtitle, the grantor shall have the right to, and must at the option of the distributor, repurchase all merchandise sold by the grantor to the distributor, and the distributor must sell the merchandise to the grantor, at a price equal to:

(1) An amount agreed on by the parties; or

(2) (i) With respect to merchandise that is still in its original condition, is part of the grantor's current product line, and was shipped within 6 months of the cancellation or nonrenewal, the purchase price paid by the distributor; and

(2) (ii) With respect to all other merchandise, including samples, display models, and damaged merchandise, the wholesale fair market value of the merchandise less depreciation, or the purchase price paid by the distributor, whichever is less.

(b) The repurchase requirements under subsection (a) of this section shall be completed within 30 days after the effective date of cancellation or nonrenewal, unless the parties agree otherwise."

3. Wisconsin; BFG ¶4490.06

"Sec. 135.045. If a dealership is terminated by the grantor, the grantor, at the option of the dealer, shall repurchase all inventories sold by the grantor to the dealer for resale under the dealership agreement at the fair wholesale market value. This section applies only to merchandise with a name, trademark, label or other mark on it which identifies the grantor."

4. Connecticut, BFG ¶4070.02

Sec. 42-133f (c). Upon termination of any franchise the franchisee shall be allowed fair and reasonable compensation by the franchisor for the franchisee's inventory, supplies, equipment and furnishings purchased by the franchisee from the franchisor or its approved sources under the terms of the franchise or an ancillary or collateral agreement; provided no compensation shall be allowed for personalized items which have no value to the franchisor.

In the following section of this paper we outline a number of matters relating to programs to convert either an employee sales force or a traditional, non-franchised dealer system to a franchised program.

III. Changing an Employee Sales Force or Independent Dealership System to a Franchise Program

1. **Why change?**

a. Benefit to both franchisor and franchisee by achieving uniformity of quality standards.

b. Increased revenue to system.

- Franchise and monthly licensing fees.
- Royalties.
- Advertising fees.

c. Offering Circular is effective disclosure piece.

d. Potential application of Franchise/Business Opportunity Laws.

2. **Conversion of Current Employee or Non-Franchised Dealers.**

a. Sell the opportunity.

- Benefits of franchising to the system.
- Enhancements to convert to franchise.
  - Fee waivers.
  - Payments.
  - For cause termination.
  - Make some programs available only to franchised dealers.

b. Could require at end of contract term, but better if voluntarily done.

- Terms may be staggered and system conversion may take too long to meet business goals of the conversion.
- Easier to work with individuals who are not forced.

c. Consider Release of Claims as part of conversion.

- Bring issues/problems to surface and deal with them.

d. Easier to sell franchises if prospects talk to dealers who have converted.

e. Do not pressure dealers, but do effective sales job.

f. Consider enhancements/changes to improve communications.

- Ombudsman.

- Dealer Advisory.

g. Consider requiring franchise sign-up upon transfer of non-franchise dealerships.

3. **Administrative impact that business people must understand.**

a. Time and expense to develop documentation and meet regulatory requirements.

b. Training of sales people to effect compliance with franchise regulations.

c. Annual renewals and amendments to offering circular.

d. Program changes may require offering circular amendment and therefore takes longer to effect change.

e. Increased disclosure that Company may not like.

- e.g., litigation.

f. Increased government regulation and need to monitor legislative activity.

g. Once change is made, difficult to return.

h. Varying state rules and regulations.

i. Central administrative controls; increased in-house legal needs.

j. Ongoing training, compliance systems and documentation.

4. **Lessons.**

a. Conversion is possible but not easy.

b. Requires serious commitment from management and acceptance and acknowledgment of fact that franchising is a different way of doing things and it is not merely the status quo, with an offering circular.

c. Make dealers part of the process and explain exactly what you are doing and why. Be up front about the program.

d. Explain to current dealers what is in it for them.

e. Recognize that not all employees/dealers will qualify for the new program

f. Make it as voluntary as possible with no adverse consequences for not converting.

In the last section, we outline a number of issues relating to combination franchising in the context of a product distribution program.

IV. Combination Franchising

Overview

Combination franchising is one of the latest innovations being explored by marketers. Simply stated, combination franchising is an arrangement under which one franchisor, dealership, or distribution system adds on another franchised service or product for the purpose of maximizing services and sales at a given store or outlet. It is not a "joint" franchise and does not involve creating a new franchise or trademark. Below, we discuss some aspects of combination franchising.

Benefits

Combination franchising is an ideal way for a lesser known franchise, dealership or distribution system to benefit by associating itself with a stronger franchise, or for a national franchise to strengthen its presence in a given market by associating with "local" franchise which is particularly strong in a particular region. It allows a party to supplement its core services or products with an additional service or product which is likely to appeal to a given regional market.

Such arrangements, for example, would enable a national fast food hamburger franchise to tailor its dessert menu for different markets. This might involve having a local Florida franchise specializing in key lime pies to establish upscale concession boutiques at the franchisor's outlets in Florida, or having a popular Pennsylvania franchise specializing in Dutch apple pie to do the same at the franchisor's Pennsylvania outlets. Indeed, parties could vary their combination franchising from outlet to outlet to take advantage of local market trends or preferences. In our fast food example, this might involve establishing donut concession boutique at one outlet, an ice cream concession at another and a cookie concession at another.

Structure

One of the first issues to consider in combination franchising is the structure, which can range from a full scale joint development project to straightforward licensing arrangements.

Joint Development. Joint development involves developing property owned jointly, leased jointly or owned by one party and leased in part to another for the purpose of combination franchising. An example would include the joint development of a service station and fast food franchise restaurant. Joint development typically involves a greater commitment of resources and as a result is generally undertaken by two parties who have already thoroughly tested the market (and each other) by way of less costly, simpler arrangements. It generally involves the development of premises "from the ground up" or involves other major renovation work for the express purpose of combination franchising. By contrast, other less expensive arrangements , which shall be our focus below, involve making a portion of the existing premises available for the marketing of the second franchised product or service on mutually agreeable terms.

Licensing Arrangement. By far, the simplest arrangement for facilitating combination franchising is a straightforward license agreement under which one franchisor (the licensor), for example, grants a license to another franchisor (the licensee) to occupy and use a designated portion of the licensor's premises in accordance with negotiated terms. Use of a license agreement, in lieu of a lease or sublease, enables the parties to avoid the peculiarities of each state's real estate law and landlord/tenant court systems (in the event of litigation.)

Key Issues In Licensing Agreements for Combination Franchising

The Parties

Combination franchising can involve as few as two parties (e.g. two franchisors using company-operated outlets) or can be expanded to accommodate several other parties (i.e. franchisees of the two franchisors.)

Franchisor to Franchisor. For purposes of testing a particular market or a particular franchise combination or for purposes of exercising greater control, some parties, such as franchisors, choose to limit the combination franchising to the two franchisors of the products or services in question. The parties can accomplish this goal through a license agreement between the two franchisors requiring the use of company-operated outlets and personnel in providing the services or products in question.

Franchisee to Franchisee. Where the franchisors wish to make the combination franchising available to their respective franchisees, the parties can arrange for the respective franchisees themselves to enter into license agreements. A master agreement between the two franchisors might also be useful under such circumstances.

Franchisor to Franchisee. In some cases, the two franchisors will enter into the license agreement, but one of the franchisors may elect to fulfill its obligations through one of its local franchisees. That franchisor will typically amend the local franchisee's franchise agreement to incorporate the terms of the license agreement, thereby making any violation of the license agreement a default under the franchise agreement. As noted below, the franchisor in such cases, often reserves the right to cure any violations of the franchisee.

Preliminary Obligations. The parties should consider the following types of issues and address them in the license agreement:

Type, style and location of licensee's kiosk or designated service area

Size and layout of signs

Review of any restrictive covenants or other restrictions contained in underlying lease

Responsibility for applying for the required permits [Note: If permits are not already in hand, the license agreement obviously will need to contingent upon obtaining them within an agreed upon time frame.]

Responsibility and allocation of cost for installing the kiosk and related equipment in the host facility

Grant of License. The grant of license should describe the precise nature and extent of licensee's right to a occupy and use the premises, including a precise description or diagram of the portion of licensor's premises to be used by the licensee. Licensees shouldn't forget to address basic operational needs such as the right of non-exclusive pedestrian and vehicular ingress and a egress throughout the premises, as well as access to storage space and refrigeration coolers.

Occupancy Charges. These charges typically are based on a percentage of gross sales, along with a proportionate share of utility costs, but flat rates or other arrangements are obviously possible. Where percentages are used, the licensor should request the right to audit the licensee's books and records to ascertain to its reasonable satisfaction the amount of gross sales per month.

Term. The term of the agreement obviously is an important subject of negotiation, based on various considerations such as whether the parties are merely testing the market, or whether the parties have moved beyond mere testing. Parties should reserve the right to terminate the agreement under the following circumstances:

-where one of the parties is a franchisee at the outset of the agreement, but subsequently loses its right to the franchise.

-where the parties are franchisors using company-operated outlets and one of the parties elects to convert its operation to a franchisee-operation. In such cases, the parties may wish to require the terminating party to use good faith efforts to facilitate the new franchisee entering into a new license agreement.

- where either party violates material terms of the license agreement and fails to cure such violation after notice. In cases where franchisees are the parties to the license agreement, the respective franchisors sometimes reserve the right in a master agreement to cure the violation and to succeed the terminated licensee.

Use and Operation of Premises. There are a range of operational issues which must be addressed in the license agreement in order to facilitate combination franchising. These include the following:

- Maintenance Responsibilities

- Hours of Operation

- Standards of Operation

- Miscellaneous Business Issues (e.g. Whether to use one cashier or two? If one cashier is used, how should funds be transferred from one party to the other? How should cash shortages be handled? Etc.

Trademarks and Trade Names. Since the two parties' respective trademarks will be displayed at the premises, the parties may wish to include provisions ensuring that this arrangement does not imply any rights for the parties to use each other trademarks for any other purpose (including advertising), without prior written consent of the owner of the marks.

Confidential Information. Since the two parties will work in close proximity and may be exposed to each other's confidential information, trade secrets or proprietary information, provisions protecting against the disclosure of such information are a good idea.

Indemnification. Typically each party indemnifies the other for losses resulting their respective acts and omissions in the performance of the term of the license agreement.

* * * *

Conclusion. Combination franchising offers unique opportunities for marketers to strengthen their own franchise, distribution system or dealership by making a second franchised product available to its customers. Although a variety of operational issues must be addressed to implement such arrangements, in most instances the issues can be readily resolved through an appropriate licensing agreement.

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