



# NEWSLETTER

*A quarterly update on intellectual property topics.*

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## TRADEMARK LICENSES AND THE NEW FRANCHISE RULE

Many trademark license negotiations are conducted without considering whether the complex regulatory framework of state and federal franchise laws might turn an apparently simple license into a regulated franchise transaction. The consequences of failing to comply with the franchise laws can be serious, including a return of all payments made under the license.

On July 1, 2007, the long-awaited amendments to the Federal Trade Commission's Franchise Rule became effective. Among the changes made by the new rules are new exemptions for transactions involving sophisticated parties, which should alleviate the risk of a trademark license being deemed a franchise under federal law. However, care must still be taken to ensure compliance with state franchise laws that may not reflect these new changes.

The franchise laws consist of two overlapping regulatory schemes: federal regulations enforced by the FTC and state laws defining and regulating franchise transactions.<sup>1</sup> Much like the securities laws, franchise regulations seek to protect persons who purchase franchises by requiring franchisors to make written disclosures regarding various business and financial aspects of the franchise and the franchisor.

The FTC defines a franchise as any continuing commercial relationship whereby (a) the franchisee offers, distributes or sells goods or services that are identified by a trademark, service mark or other commercial symbol designating the franchisor; (b) the franchisor has significant control over or provides significant assistance regarding the franchisee's method of operation, promotional activities, management, marketing plan or business affairs; and (c) the franchisee must pay the franchisor as a condition of obtaining or commencing the franchise operation. 16 C.F.R. § 436.1(h). State franchise laws follow this model to define "franchise."

Because the center of any franchise is a license to use the franchisor's brand, a royalty-bearing license will satisfy parts (a) and (c) of the FTC definition of a franchise. Because a trademark licensor is required to exercise control over the quality of the goods and services offered by the licensee, the distinction between a trademark license and a franchise is the type and degree of control exercised by the franchisor and licensor. The quality control that a trademark owner may deem appropriate can range from "passive" controls, such as periodic product testing and facility inspections that focus solely on the quality of the goods and services, to active control over aspects of the licensee's "method of operation," such as the location of the licensee's business, hours of operation, and business management practices. The more extensive the controls exercised, the more likely that the agreement will be deemed a franchise.

The FTC regulations on franchising contain several exemptions that limit the potential for a license to fall into the "franchise trap." These include the "fractional franchise" exemption and, under the new FTC rule, certain "sophisticated investor" exemptions.

Fractional franchises are those relationships where the franchisee (a) has at least two years of experience in the type of business being franchised; and (b) the parties reasonably anticipate that the franchisee's revenues under the new arrangement will not exceed 20% of its total revenues in dollar volume. Through this exception, the franchise laws acknowledge that franchisees with sufficient prior experience and non-franchise revenues do not need the protections provided by the mandatory disclosures of the franchise laws.

The new rule also includes three "sophisticated investor" exemptions that will help exclude certain trademark licenses from regulation: (a) the large franchise investment exemption; (b) the large franchisee exemption; and (c) the insider exemption.

Under the first new exemption, franchise transactions requiring an initial investment of at least \$1,000,000 (excluding the cost of unimproved land and financing provided by the franchisor) will not be subject to the FTC's disclosure requirements. The FTC recognizes that purchasers who are able and willing to invest such large amounts have enough investment experience to make pre-sale disclosures unnecessary. The new FTC rule also exempts franchise transactions where the franchisee (or its parent or affiliate) has been in business for at least five years (though not necessarily in the franchised business) and has a net worth of at least \$5,000,000. As with the other exemptions discussed above, the new FTC rule recognizes that franchisees with this level of business experience and wealth are unlikely to need the protections that pre-sale disclosures extend to average investors.

Finally, the new FTC rule does not require disclosures where the purchaser of 50% or more of the franchise has served the franchisor for at least 2 years as an officer, director, manager responsible for the offer and sale of its franchises, an administrator of its franchise system or has owned at least a 25% interest in the franchisor within 60 days of the date of the transaction. This exemption permits franchisor insiders to transition into the franchised business and recognizes that insiders who already know the franchisor's business do not need the protections of pre-sale disclosures.

These "sophisticated investor" exemptions and the traditional "fractional franchise" exemption should help many trademark licensors avoid stumbling into the franchise trap. However, these safe harbors under the FTC rule may not be recognized by state franchise laws. For this reason, any royalty-bearing trademark license should be carefully checked to determine whether it constitutes a franchise under both federal and state law.

— J. Michael Monahan

1. States that regulate franchise offers and sales include California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

# FIRM UPDATE / ANNOUNCEMENTS

## NEW ASSOCIATE

**David M. Beeman** has joined the firm as an associate. He received his J.D. from Northwestern University this summer, his B.F.A. from the University of Illinois at Champaign-Urbana in 1999 and his M.P.P. from the University of Chicago in 2004.

## PRESENTATIONS

**Matthew A. Griffin** will give a presentation on "Practical Tips on Intellectual Property Law: Intellectual Property Transactions and Management" on September 28, 2007, at The John Marshall Law School in Chicago.

**Ashly Iacullo** and **Kristen S. Knecht** moderated a panel discussion on "Careers in Intellectual Property" on September 18, 2007, for the IP Committee, Young Lawyers Section of the Chicago Bar Association.

**Jonathan S. Jennings** will speak on trademark law at the Intellectual Property Law for Non-IP Attorneys seminar on October 2, 2007, at the Chicago Bar Association.

**Mark V. B. Partridge** will give a presentation entitled "Intellectual Property Update: Resolving Disputes with Cybersquatters." on September 27, 2007, at the Illinois Institute for Continuing Legal Education's "Hot Topics in Business Law" program in Chicago. On October 4, 2007, **Mark** will speak on "Trademark Law" at the Instituto Dannemann Siemsen in Rio de Janeiro, Brazil.

**Sanjiv Sarwate** will give a presentation on "Trademark Enforcement Theories: Likelihood of Confusion and Dilution" at ALI-ABA's "Fundamentals of Trademarks, Copyrights, and Unfair Competition: Protection and Enforcement in the Digital Age" program on October 12, 2007, in Chicago.

**Belinda J. Scrimenti** gave a presentation on September 17, 2007, on "The Foundation of International Enforcement Against Counterfeiting - International Trademark Registration and Border Control Registration Protections" at the IQPC Legal IQ 2d Annual Anti-Counterfeiting and Brand Protection Conference in New York.

**Joseph N. Welch II** will be speaking at the AIPLA Annual Meeting in Washington, DC. on October 19, 2007, on "Searching for the Key to Key Words: What is Fair? What is Use? What is Fair Use?"

**Uli Widmaier** and Professor Graeme Dinwoodie of Chicago-Kent College of Law will be conducting a panel discussion on "Keywords and Trademark Use" in Chicago on October 23, 2007. On November 15 and 16, 2007, **Uli** and Gerhard Bauer, Chief Trademark Counsel of DaimlerChrysler AG, will be teaching a 2-day seminar entitled "Introduction to Trademark Law" for IP attorneys and in-house counsel in Frankfurt, Germany, under the auspices of the FORUM Institute for Management.

## PUBLICATIONS

**Joseph N. Welch II** will have an expert commentary on the highly publicized and recently settled *Google, Inc. v. American Blinds and Wallpaper, Inc.* case published by Lexis Publishing on the Lexis.com website.

## APPOINTMENTS

**Ashly Iacullo** has been appointed co-vice chair of the Intellectual Property Committee of the Young Lawyers Section of the Chicago Bar Association.

**Jonathan S. Jennings** has been appointed to the ABA Section of Intellectual Property Law's Books Editorial Board. He continues to also serve on the Section's Leadership Council.

**Kristen S. Knecht** has been appointed co-chair of the Intellectual Property Committee of the Young Lawyers Section of the Chicago Bar Association.

**Mark V. B. Partridge** began his term as President of the National Speakers Association, Illinois Chapter.

**Jared D. Solovay** has been appointed co-chair of the Creative Arts Committee of the Young Lawyers Section of the Chicago Bar Association.

## TEACHING

**Phillip Barendolts**, **Thad Chalomentiarana**, **David C. Hilliard**, **Janet A. Marvel** and **Joseph N. Welch II** are teaching a course on "Trademarks and Unfair Competition" at Northwestern University School of Law in Chicago, IL.

**Mark V. B. Partridge** and **Sanjiv Sarwate** are teaching an L.L.M. level course on "Trademark Law" at The John Marshall Law School in Chicago.

## NOTEWORTHY

**Raymond I. Geraldson, Jr.**, and **Robert W. Sacoff** were identified as Luminaries within the field of intellectual property in a survey of intellectual property lawyers conducted by Informa plc, the publisher of *Trademark World*, *Patent World* and *Copyright World*.

**Raymond I. Geraldson, Jr.** was also named a Leading Lawyer in Intellectual Property Law by *Chicago Lawyer* magazine.

**Robert W. Sacoff** was recognized as a Trademark Experts' Expert by the *World Trademark Review*, which described him as "a leader of the trademark bar and well-recognized speaker and author on trademark law."

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