



# FRANCHISE CLUB

DON'T GET SUCKERED BY AN ILLEGAL LICENSE

AGREEMENT

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## **Franchise Club**

What's the first rule of the franchise club? Follow the rules. Recently, a client came to me, distraught over a fight he was having with another company. My client owns a chain of big entertainment complexes. At each location, he uses part of his building to run a unique business that he licenses from this other company. Under the license agreements, the other company the licensor provides my client with an elaborate manual and trademarked material to run the licensed business at each complex. In turn, my client pays a share of his revenues from these businesses – a royalty – to the licensor.

These licensed businesses had become particularly profitable for my client and he wanted to keep them. If no one got greedy, this was a good deal for both parties and an increasingly big part of my client's success. Turns out that was a big if.

The licensor was now insisting that my client sign a new agreement. The royalty fees would skyrocket. The new agreement would also prevent my client from expanding. That is, he wouldn't be able to open any new entertainment complexes without the licensor's approval. In effect, this new agreement would put the licensor in charge of my client's expansion plans and potentially choke off my client's ability to grow his business.

Then the fight broke out. The licensor threatened my client. If my client didn't sign the new agreement, the licensor would enforce non-compete provisions in the existing license agreements that would shut down my client's businesses for a year. My client was trapped.

Or so he thought.

My client didn't realize and the licensor was not about to admit that the existing license agreements violated franchise law.

## THE LAW

In 30-plus states, the sale of a franchise is highly regulated. Most states impose stiff penalties if you fail to follow these laws.

It all starts with the somewhat surprising definition of what constitutes a franchise. Usually, you're dealing with a franchise whenever you enter into an agreement,

which involves the following three elements:

You provide someone with a marketing plan or system to sell any goods or services;

Your plan or system includes use of your trademark or other symbol; and

You charge a fee for your plan or system.

So when the licensor sold – for that royalty fee – my client the right to use the licensor's elaborate business plan and trademark, the licensor was really selling my client a franchise. Whoops!

## OPENING PANDORA'S BOX

If you sell a franchise, you're opening up something halfway between a can of worms and Pandora's Box. Do it wrong and you'll have a real mess on your hands.

Before you sell a franchise in most states, you have to register your franchise and you have to provide a ton of disclosure to each prospective franchisee. Both of these requirements are a lot of work and cost a small fortune. As a rule of thumb, you're going to spend \$100,000 or so, and a lot of your own time and effort, to prepare the initial paperwork and register. It doesn't make sense to sell just one or two franchises. Instead, before you start the process, you want to know you have enough demand to sell 10 or more franchises. Otherwise, franchising could be more trouble than its worth.

And what if you get the nifty idea to, say, skip the rules and just sell a franchise or three without the paperwork? Stop. Don't do it! After countless horror stories of franchisors abusing franchisees, most states gave their franchise laws some real teeth. If you don't comply with the franchise laws, you face everything from fines and penalties to imprisonment. If you willfully ignore franchise laws, you can be convicted of a felony and go to prison for years. Also, while you're facing jail, your franchisees get a free pass to terminate whatever agreements they signed with you. Sometimes, you even have to pay back every penny your franchisees spent on their franchises.

## THE RULES RULE

In our case, we diplomatically pointed out to the licensor's attorney the franchise requirements that the licensor had overlooked. The licensor hadn't registered or provided any disclosure. As a result, the licensor's agreements were illegal franchises and were unenforceable. The licensor reacted like he was going through the five stages of dying – denial, anger, bargaining (lots and lots of bargaining), depression and, eventually, acceptance. Finally, the licensor agreed to release my client from the license agreements and their crippling non-compete covenants. The licensor even generously agreed to stay out of our territory for a year while my client transitioned to a new program. The wonders a spirited discussion and knowledge of the law can work!

The lesson here for all CEOs is to follow the rules. You'll profit more by jumping through the hoops to comply with the law than you will by jumping through rings of fire because you broke the law. After all, if you're in business, you want to do what it takes to win.

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