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Expanding The Brand: The Role Of Trademarks In The Growth Industry Of Franchising

By Linda A. Tancs

NORRIS, McLAUGHLIN & MARCUS, P.A.

By all accounts, franchising is a growth industry, accounting for \$1 trillion in annual retail sales in the U.S. alone. Similarly, in some European countries, the total turnover of franchising is as high as 10 billion in U.S. dollars. In a franchise arrangement, there is a community of interest in marketing goods or services sold under a trademark in a business operated under the license. This article focuses on trademarks as an important facet of franchise relationships and surveys the development of this business model internationally.

The Proprietary Mark

The successful franchisor knows the importance of identifying and obtaining registration of all proprietary marks on the Principal Register of the U.S. Patent and Trademark Office. Registration on the Principal Register confers numerous benefits on the trademark owner, such as (i) providing a constructive date of first use of the mark at least as early as the filing date of the application, thus giving the registrant nationwide priority as of that date, except as to certain prior users or prior applicants; (ii) recovery of profits, damages and costs in a federal court infringement action and

Linda A. Tancs, a member of Norris McLaughlin & Marcus in Somerville, New Jersey, counsels clients in intellectual property, franchising, entertainment, information technology, e-commerce and general business matters.



Linda A. Tancs

the possibility of treble damages and attorneys' fees; (iii) the right to deposit the registration with U.S. Customs to stop the importation of goods bearing an infringing mark; (iv) the possibility of achieving incontestability of the registration, which provides limited grounds for an adversary to attack the registration; and (v) the availability of criminal penalties and treble damages in an action for counterfeiting a registered mark.

A franchisor's proprietary marks can be displayed on packaging or labels for goods, service literature for service marks, or via one or more Internet domain names. However it is displayed, to preserve the propri-

etary nature of the mark, the franchisor should, at a minimum, ensure that a franchisee acknowledges and agrees that its right to use any proprietary mark is derived solely from the franchise agreement and is limited to the conduct of a business allowed by the agreement. Similarly, the franchisee's use of a mark, together with any goodwill established by such use, should not give the franchisee any goodwill or other interest in a mark. Further, the franchisee should not use any mark as part of a corporate name or with a prefix, suffix, or other modifying words, terms, designs or symbols, or use the mark in any other manner not expressly authorized by the franchisor.

In the case of a mark for which a federal application is pending and no state trademark registration exists, then the applicable state law addressing business opportunities must be addressed. In some instances, the franchisor's sales or marketing program surrounding an unregistered mark may bring the arrangement within the ambit of a business opportunity law. Failure to comply with such laws could result in a number of remedies, including buy back of the franchise by the franchisor for fair market value or state-ordered rescission of the franchises offered by the franchisor. Any remedy is likely to be extremely costly to the franchisor.

Maintaining Source Identification

To maintain the uniformity of the franchised brand and the image of each franchise as part of a national system, it is

Please email the author at latancs@nmmlaw.com with questions about this article.

essential that the franchisor monitor the use of any mark being used by the franchisee in the scope of the franchised business. The monitoring, or quality control, process is critical to the preservation of the validity and integrity of the mark. A franchisor's failure to ensure that the mark is being employed properly in the operation of the franchise may result in the mark being deemed to have been abandoned. Indeed, Section 1127 of the Lanham Act states that "a mark shall be deemed to be 'abandoned' . . . (2) when any course of conduct of the owner . . . causes the mark . . . to otherwise . . . lose its significance as a mark . . ." 15 U.S.C. § 1127.

Quality control can be accomplished in several ways. One method is to establish logo books and guidelines for the display of marks and to include these materials in a policy and procedure manual. These guidelines may include, for instance, mandating the use only of displays, labels, forms, and other materials imprinted with the marks as prescribed from time to time by the franchisor. Another method of quality control involves the franchisor's requirement that the franchisee furnish samples of products, or written descriptions of services, to the franchisor for review and continuing approval. A franchisor may also indicate in its franchise agreement that it shall have the right to enter and inspect the franchisee's place of business to ensure that operations meet the quality control provisions established by the franchisor. Finally, the franchisor has an obligation, as part of its quality control function, to modify or discontinue use of a mark as commercial conditions dictate and to inform the franchisee regarding any modification, discontinuation, or even use of additional or substitute marks.

International Considerations

Franchise regulation is proliferating in Europe. In Italy, for instance, regulations require that both the franchisor and franchisee act in good faith, and a written franchise agreement must exist and must contain certain information such as any territorial limitations, renewal rights, and a description of know-how applicable to the franchise. In other countries, such as Sweden, there is no specific franchise law but rather a patchwork of laws that impact the establishment and operation of a franchise – namely, The Contract Act, The Agency Act, The Competition Act, and intellectual property legislation. Initiatives are currently underway in Sweden and other parts of Europe to establish franchise-specific legislation.

Countries outside Europe also impose obligations to make disclosure and register

franchise agreements. Disclosure laws generally involve providing the prospective franchisee with certain categories of information covering the franchisor's business, including the identification of trademarks, funds to be paid by the franchisee, marketing and training obligations, and the franchisor's litigation history. Disclosure is typically required within a certain number of days prior to the franchisee executing a contract. Registration requirements relate to the registration of the offering with a governmental authority before the offer of the franchise. Examples of countries implementing disclosure and registration requirements are Indonesia, Mexico and Taiwan. Furthermore, China is widely viewed as the biggest growth market, a development taken very seriously by the Chinese Ministry of Commerce (MOFCOM). In fact, on March 10, 2005, MOFCOM issued a "Circular on Strengthening the Administration of Franchise Activities." Concerned over the perpetration of fraud on small investors, MOFCOM has asked governmental departments to increase their supervision and administration of franchise activities to prevent fraud by implementing qualification controls and vetting promotional campaigns.

In addition, other countries such as Malaysia have implemented extensive franchise legislation covering disclosure, registration and relationship issues. "Franchise relationship" laws restrict a franchisor from breaking a relationship or failing to renew a franchise unless good cause exists. Moreover, even where no formal franchise regulation exists, voluntary codes of conduct may apply. For instance, the European Franchise Federation's (EFF) Code of Ethics for Franchising has been adopted by member associations of the EFF such as the British Franchise Association (BFA). BFA accredits its own franchises for membership in its association based on a favorable review of standards involving the franchise's finances, business activity, disclosures made to franchisees, and the terms of the franchise agreement.

Other international developments bear on franchise relationships as well. For instance, the International Institute for the Unification of Laws (UNIDROIT) adopted a model franchise disclosure law in September 2002, setting forth, among other things, the format and timing of disclosure of franchise operations to prospective franchisees. It is uncertain whether or to what extent the international community will adopt the model provisions in national legislation as it does not have the force of law of an international convention. In contrast, earlier in 2002 existing franchise agreements affecting trade upon European Union

(EU) member states were required to be revised to comply with the new "block exemption" in EU competition law governing franchising. Simply put, a block exemption provides safe harbor against the applicability of Article 81 of EU competition law to certain classes of transactions. Article 81 prohibits companies from entering into agreements or engaging in concerted practices that have the purpose or effect of restricting or distorting competition in the EU. The "old" block exemption provided lists of provisions in franchise agreements that were either prohibited, sometimes permitted, or acceptable. The new block exemption, on the other hand, provides more complex conditions for the exemption, but generally, the more significant the transfer of know-how, the less likely it is that the franchise agreement's restraints on competition will fail to meet the exemption requirements.

Enforcement

Ownership of a mark carries with it the obligation to police the mark. Indeed, the distinctiveness and strength of the mark can be diminished if action against infringers or users of similar marks is not taken. It is not unusual for a successful franchisor to discover impairment of its trademark rights, requiring the institution of infringement actions or perhaps actions involving claims of unfair competition, deceptive trade practices, false advertising or trade secret misappropriation. Conversely, a franchisor may face claims of a third party that the franchisor's mark infringes some proprietary right of that third party. In either event, the franchisee has a critical role in the protection and enforcement of the brand. The franchisee should notify the franchisor promptly of any third party's use of the mark or any imitation of which the franchisee has knowledge. Also, the franchisee should promptly notify the franchisor of any third-party claim against the franchisee arising from the franchisee's use of the mark. In any defense or prosecution of any litigation relating to the marks, the franchisee should cooperate fully with the franchisor to carry out any such defense or prosecution.

Summary

Franchisors expend considerable time, skill, effort and money to develop and protect a unique business system identified by one or more marks. Likewise, franchisees desire to use and obtain benefits from the system. The success of the parties' shared interest depends on their collaboration to protect, maintain and promote the brand consistent with the principles discussed above.