

LICENSING vs. FRANCHISING

[Including “How to Sell Licenses”]

A White Paper and short discussion about greatly lowering the cost of business expansion through low cost licensing rather than investing in the huge expense of franchising. Also, “How to take the fear out of expanding your business”.

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[Please note: If you wanted **LICENSING IN A NUTSHELL**, press [here](#) to change].

What You Have to Know

- **There are Many Ways to “Skin a Cat”.** This paragraph is the most important idea of this article; i.e. the “many ways to skin a cat” idea. Though this particular article discusses “licensing versus franchising” as methods of expanding a business, it is important to note that these are just two paradigms that can be used. There are many other methods to use, and each factual situation will dictate the best possible expansion avenue to pursue. **Maybe more than half of my clients pursue something other than licensing or franchising once they learn what is available...**and usually *at least* one-fifth of the costs in legal fees compared to franchising.

Why Consider “Licensing”?

- **Licensing is Lower Cost and Can Be Done Quickly.** If you are thinking about expanding your operation through franchising, licensing may be an alternative because (1) it is substantially less expensive (*sometimes one-twentieth of the cost of franchising*), and (2) it takes about ten to fifteen business days to complete rather than months and months for franchises. As to costs, just the franchise registration fees paid to the States *aggregate* somewhere around \$6,000 (*Almost the cost of a license agreement or a set of license agreements.*). Licenses have no registration fees. So if you qualify for licensing, the legal fees are almost the same as the filing fees paid to the States for franchising.

- **Avoid Complex Government Regulation.** There is little or no government regulation in licensing, and there is substantial and complex government regulation in franchising. **One such regulation which may prohibit immediate franchising is the requirement of have three years of financial records, and this may at least delay many from franchising until they can obtain the required financial records and incur the accounting and auditing fees:**

The FTC Disclosure Statement requirements include: *“A balance sheet (statement of financial position) for the franchisor for the most recent fiscal year, and an income statement (statement of results of operations) and statement of changes in financial position for the franchisor for the most recent 3 fiscal years. Such statements are required to have been examined in accordance with generally accepted auditing standards by an independent certified or licensed public accountant.”*

- **You Can Begin Licensing Immediately while with Franchise You may have to Wait several months, a year or more.** Before you begin franchising, you may (a) have to wait for the completion of three years of

operations in order to obtain the financial records discussed above, and (b) you must have a registered trade name or trademark which usually takes one year to eighteen months to complete if you do not have one at the time you wish to start franchising. Licensing, with its limitations that franchising may not have, can be used to test the franchise market at a substantially lower cost; i.e. see if licensing works before you go “franchising”.

- ***Business Goals Often Can Be Met.*** It is often possible to draft a license agreement that achieves the goals of the licensor and does not violate the various franchising laws. But (this “But” is important”) usually, one has to change or eliminate some portion of the business vision in order to comply with the requirements to license; e.g. modify or eliminate certain controls, sometimes change the method of the initial payment, etc.

- ***Existing Businesses as Potential Licensees.*** Existing businesses often buy a license and add the product or service to that existing business; this allows the licensee to keep his “bread winner” business going while he tests the licensing operations and thus reduces the risk on the acquiring the license.

- ***Much Less Work on Daily Basis.*** The day-to-day business operation of a licensor is customarily much less work and complex than the business of being a franchisor. If you become a franchisor, you generally have to give up the operations of your own business and enter the full time business of being a “franchisor”. I have licensors that have the job of going to the mailbox and collecting checks each month; one, for example, collects 60 checks of \$1,000.00 each...and this is for the use of a trademark.

- ***Licensing More Effective in Difficult Economic Times.*** In a time when America’s work force is being down sized, in many businesses the market for selling licenses is correspondingly expanding, because these displaced people need a way to replace their lost “living wages. Additionally, there are more qualified and desirable people available on the market to become licensees which makes business expansion quicker and more effective. In essence, the market for selling licenses in many businesses is actually expanding in difficult economic times. And when you add in the fact that licenses are often easier to get into because of a lower purchase price and quick set up, licensing is usually superior to franchising for the new licensee. Licensing is also superior to franchising for the Licensor because of the (a) quick set up, and (b) the substantially lower cost in legal fees.

A Quick Overview of Licensing

- Licensing is a business structure and method of expanding the distribution of goods and services. Rather than create a franchising business structure with the substantial costs involved, an entrepreneur who wishes to expand its business *may* be legally able to use a licensing legal structure. ***Usually a quick no-charge telephone conversation with experienced counsel can tell you if licensing will work in a particular situation. (Note: I do this several times a day, so feel free to call.)***

- As in franchising, in licensing *under certain circumstances* there can be (i) an initial upfront fee, (ii) continuing royalties, (iii) monthly license fees during the term of the agreement, (iv) exclusive territories, and (v) long or short term agreements.

- **A Personal Observation.** I see many people that qualify for licensing not go forward, and many of them have products or services that when encased as a business opportunity potential licensee would grab up in a New York minute. I see so much money left on the table! Most of it is there because of the fear to try something new...even though there is no big secret in doing it. All one needs is just common sense and a call “here and there” to someone who has an answer that you need. Have you noticed that some of the dumbest people you know make a lot of money? Most of them just buy low and sell high...and the dumbest can follow that adage. That, for the most part, is what licensing is all about; i.e. having licensees who buy low and sell high, make a profit, and give the Licensor a piece of the pie.

Difference between Franchising and Licensing

- Franchising and licensing as a means of expanding a business are often confused with one another. However, franchising and licensing come from two distinct areas of the law. Franchising is based on securities law and licensing is a form of contract law.

- *What does this mean to the non-lawyer?* It means that if one takes up franchising as a means of expanding a business, then compliance with the franchise laws, like the securities laws, requires registration of the franchise in the applicable jurisdictions and the preparation of a Disclosure Statement for the non-registration States. On the other hand, licensing is merely a contract between two independent contractors and franchise registration is not required.

- Here is the effect: It’s in the pocket book! Franchising creates more work for lawyers in complying with all the registration requirements, and consequently it is far more expensive to go the “franchising route” than down the licensing road which requires substantially less legal work.

THE FRANCHISE LAWYER’S SCARE!

Because lawyers usually make at least five times more money in preparing franchise documents than preparing licensing documents, some of them make fear statements exalting the dangers of licensing to scare potential clients into franchising and pay the high legal fees. They cite cases where someone that uses licensing is sued, because they are in fact a hidden franchise. Make no mistake about it, this happens. But it happens where the party sued should not have been in a licensing model in the first place. If you and your lawyer are careful (*like you should be in any legal matter*) in analyzing your particular factual situation to determine if you qualify for the licensing model, then there should be no problem if the lawyer properly directs you to the appropriate legal model. If a franchise lawyer tells you licensing is a dangerous path to follow, it probably is a good idea to get a second opinion *unless* you totally respect the integrity of your lawyer...which often is the case. However, usually, the cost of the second opinion is nothing and the savings in legal fees can be astounding. (*There is a discussion of legal fees for licensing and franchising below.*)

Why Do Franchises Have To Be Registered?

- In general, the primary difference between a license and franchise situation is the amount of control that the franchisor or licensor exercises over its franchisees and licensees, respectably.

- A franchise has to be registered, because the control by the franchisor over the franchisee is what is suppose to make the money for the franchisee; i.e. the idea is that if you do what the franchisor says, then you will make money. Buying a franchise is like buying a security; i.e. the control over whether or not the buyer of the franchise or security makes money is in the hands of a third party; for the security situation it is in the control of the people who operate the company that issues the security, and for the franchise the control is in the franchisor who dictates how the franchise operates to make money.

- Thus, the government requires disclosure of the *risks* to the potential franchisees just like the government requires a disclosure of the risks in buying a new stock issue. There are government requirements of registration of both franchises and securities for the same reason; i.e. to protect the public and give the public full disclosure of all *risks* before purchasing.

There are Two Types of Franchises

- In order to understand licensing, you have to understand franchising so that you can avoid it. In practical terms there are two types of franchises: (a) intentional franchises and (b) unintentional franchises.
- The first type is the situation where someone wants to expand their business and decides to intentionally use the franchising mechanism to do it and comply with the registration laws.
- The second type is the predicament where in the effort to expand the business, franchises are inadvertently created (sometime called “hidden franchises”). These hidden franchises are often spawned from a poorly advised and drawn distribution agreement, license agreement, and other marketing formats. These are the franchises that get people into trouble!
- The problem is that both types of franchises have to be registered in the appropriate jurisdictions and the consequences of failing to do so is often substantial civil penalties and/or criminal punishment. There have been many entrepreneurs that have served substantial prison terms for selling unregistered or improperly registered franchises.
- So this area of the law is nothing to “trifle with”, so to speak.

AN IMPORTANT VISUAL AID IN UNDERSTANDING LICENSING

THE THREE-LEGGED FRANCHISE STOOL

The Legal Definitions of a Franchise So Everyone Can Understand It

You have to learn about the “*Three-Legged Franchise Stool*”. You have to know what franchising is to know how to *lawfully* avoid franchising, and you have to know how to avoid franchising to create a licensing or other mode of business expansion. Consequently since we have been talking about franchises and need to know about them, we better make it understood just what constitutes a “franchise”. First, I have to tell you the various States and Federal definitions of a

franchise are pretty clear, but the application of the facts to these definitions is highly mercurial. You may have trouble ever getting any two franchise lawyers to agree on whether or not franchise law compliance in various situations has been met.

Federal Definition of the Federal Trade Commission (Applicable in States that do not have Franchise Registration Laws)

- **THREE ELEMENTS.** The FTC “Franchise” definition has three key elements: (1) the franchisee’s goods and/or services are to be offered and sold under the trademark of the franchisor; (2) the franchisor requires the franchisee to make a minimum payment of \$500, and (3) the franchisor maintains *significant* control of, or provides *significant* assistance to, the franchisee’s operation methods. There is actually a fourth element and that is a continuing commercial relationship between the parties; e.g. eliminates non-commercial endeavors.

Author’s Note: This is important! Think of each of these three elements as a leg on a stool with three legs. This visual aid will help understand the discussion of licensing below. **THE THREE-LEGGED FRANCHISE STOOL!**

- **Leg One: Common Name Leg.** The element (*or leg of the three- legged franchise stool*) of the use of the **trademark** or common name is clear for the purposes of this discussion. You want your trademark or common name to be the rudder that moves your business expansion. “McDonalds” is the most famous example of the common trademark name of franchises.

- **Leg Two: Fee Leg.** The element (or leg) of payment of a **fee** means that franchisee must pay the franchisor at least \$500 as a condition of obtaining the franchise or at beginning initial operations. Any payments made at any time before or within six months after beginning operations shall be *aggregated (combined)* to determine if the \$500 element is present. These payments may be a requirement of the franchise agreement, or a secondary agreement (e.g. agreement to purchase goods at a certain higher price only supplied by franchisor.). However, there are some interesting ways to remove the Fee Leg and still get paid.

- **Leg Three: Significant Control /Assistance Leg.** As to the element (or leg) of “**significant control or assistance to operations**”, the key word is “significant”. Actions that trigger the application of the concept of “significant control” are (for example): marketing plans, operations manuals, site approval, personnel policies, co-op advertising, operations or marketing training, etc. This is the most complex leg, and the FTC looks at each “significant control/assistance” on its own; they evaluated each factual situation where the issue is presented to them. There are two sub-requirements for this leg to be present: (1) the control or assistance must be exerted on the *entire operation* and not just the sale of a particular product or service, and (2) the *reliance* by the franchisee on the control or assistance is important (this takes in consideration *specific and relevant* prior experience of the franchisee).

NOTE: There are additional ways to avoid the need to comply with the Federal franchise laws in the form of “Exemptions” (e.g. the Fractional Franchise Exemption) and “Exclusions” which are based on legal relationships.

The States' Definitions of Franchise (The Three Categories)

The FTC basically sets a minimum standard of what a franchisor must disclose to a prospective franchisee. Then it leaves it up to each State to add any laws it deems necessary to protect the potential franchisee. Thus, fifteen (15) States have their own franchise laws which include the definition of a franchise that must be followed (*California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, Wisconsin.*) The other thirty-five States follow the Federal Law (See above). I have used three categories to describe the various types of franchise laws of the States. They are:

1. **Category I.** In California, Illinois, Indiana, Maryland, Michigan, North Dakota, Oregon, Rhode Island, and Wisconsin, a franchise is defined as having three essential elements: (a) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor [*Significant Control Leg*], (b) the operation of the franchisee's business is substantially associated with the franchisor's trademark or other commercial symbol designating the franchisor or its affiliate [*Common Name Leg*] and (c) the franchisee is required to pay a fee [*Fee Leg*]. Please note that the Category 1 definition is similar to the Federal definition, and the Federal definition will apply to States that do not have their own franchise law. A license agreement that is prepared to avoid the need to comply with California and Category 1 States may be able to be used in the non-registration States that follow the Federal definition, usually with a few adaptive changes. However, sometimes one of the three legs has to be removed for State requirements and a different leg removed for the Federal definition; i.e. you would have two license agreements plus the changes you would need for the Category II and III States. The Licensor may have a list of States and a notation as which version of the License Agreement to use for each State.

NOTE: For example, I prepare a California License Agreement (*where I practice and which is a Category I State*) and that License Agreement is ordinarily usable in nine (9) Category 1 States plus with certain changes in thirty-five (35) States that have no franchise laws that use the Federal law for a total of 44 States ...almost all the country. For Category II States the same agreement is probably not usable for "service" businesses, but with some tweaking it can be adjusted for businesses which market "products".

2. **Category II.** Hawaii, Minnesota, South Dakota, and Washington have a broader definition of franchise which include three primary elements: (a) Franchisee is granted the right to engage in the business of offering or distributing goods or services using the franchisor's trade name or other commercial symbol or related characteristic (b) franchisor and franchisee have a common interest in the marketing of goods or services, and (c) franchisee pays a fee. The definition of a "franchise fee" may be an important element to look at in determining if the licensing model will apply in these States.

3. **Category III.** Virginia and New York are different than other States. New York, for instance, the (a) franchisor is paid a fee by the franchisee, and (b) is either essentially associated with the franchisor's trademark *or* the franchisee operates under a marketing plan or system prescribed in substantial part by the franchisor. Virginia requires the combination of (a) a prescribed marketing plan *and* (b) the substantial association with a trademark.

HERE IS THE QUESTION:

How Do You Create A License Without Creating A Franchise?

There are two key things that have to be done to create a license that does not constitute a franchise:

1. Eliminate one leg of the Three-Legged Franchise Stool.

[**Note**, that sometimes you just cannot eliminate a leg and you have to create a franchise; e.g. often restaurants where you want all the restaurant's to have the same name (*branding leg*) and you want the restaurants to look similar and/or have the same menu (*significant control over operations and marketing leg*).]

2. And make sure that the Licensee is an independent contractor in its relationship to the Licensor.

See info on Independent Contractor issue below.

[**Interesting Observation.** I have found that there are few franchise lawyers that will want to do licensing because (i) “licensing” legal work pays only a fraction of the legal fees paid for franchise work, and (ii) logically and for fair reason they have little or no experience in actually doing a license as their “mind set” is franchising law. their area of specialization.]

[**Warning to “Do-It-Yourself” People.** I want to make this clear to anyone considering Licensing without using an experienced attorney: Do not try and do this yourself without your legal counsel. There are NO forms on the internet that will get the job done! I have reviewed “do it yourself” documents from time to time, and they are always on the road to trouble. And further, it is very difficult to get them straightened out, because they have all this “wrong stuff” already done before it can be done “right”, and the “wrong stuff” is always out there to create liability to the poor soul who tried to do it himself])

The “Big Question”: What Leg Do You Eliminate?

In its most simple terms, first you have to decide what is most important to the fulfillment of your business vision in setting up the licensing model: branding a name (“branding”) or providing assistance in business operations and/or marketing of products or services (“Non-Branding”).

Branding Situations

- The branding situation usually (though not always) occurs where you *require* the licensee to use your trade name and/or logo in the marketing of your goods or services, including but not limited to the use of your name as the name of licensee's business.

- BUT (there is always a “big but”) if you *require* the branding element be used, then you pretty well must (a) give up the idea of helping your licensee by providing or suggesting a marketing plan or giving directions affecting overall operations, or (b) in the alternative, forego or delay the payment of an initial licensing fee. Otherwise you will probably have to proceed down the franchising route.

- When you *eliminate* the licensing of the trademark or common name then the effect *may* be to eliminate the “branding” feature.

Non-Branding Situations

- Non-Branding is where the Licensor *does not permit* the Licensee to use your trade name and/or logo in the marketing of your goods or services, including but not limited to the use of your name as the name of licensee's business or in a substantive or primary way.

- Where the object is to sell product or services and this can be done without branding, then allowing the licensee to operate under its own name may be the avenue to take, because here the Licensor can exert certain *limited* controls on operations and marketing that assist the Licensee in successfully selling the products or services of the Licensor.

- The application here is a license to distribute goods and services in a manner that is designed to produce profits for Licensor and Licensee.

- **Look out!** Even if you are eliminating the branding leg and keeping the operations and marketing control leg, the Licensor's controls cannot reach the status that there is so much Licensor control that the Licensee loses its legal capacity as an independent contractor, or else the Licensee may become an employee or agent of the Licensor with dire consequences. (See Below)

The Independent Contractor Issue

- The independent contractor issue is the basis of the legal relationship between the Licensor and the Licensee. They are bound by a contract entered into between them as two independent contractors.

- **In General.** The Internal Revenue Service and the income taxing authorities of the various states have guidelines to ascertain if the relationship between two parties is that of employer-employee, principle and agent, or two independent contractors that have entered into a contract for work or sale of goods or services. The essence of being an independent contract is that (in this case) the Licensor cannot tell the Licensee how to do the work required but can only tell him what the job is that needs to be done under the contract. For instance, one may not tell another the hours to do the work, equipment to use in doing the work, the sequencing of the work, the customers for the work, etc. There are approximately **20 points** in the guidelines to which an independent contractor should substantially comply to maintain that status.

- **Consequences of Violating Independent Contractor Status.** The consequences of violating the independent contractor status of the Licensee is (i) the IRS or a State will rule that the Licensee is an employee of the Licensor and will seek all back withholding taxes plus interest and penalties (this usually happens after about five years of operations, so the taxes, etc are huge!), and (ii) that in the event that that Licensee incurs civil liability for a tort (e.g. an accident) the Licensor will be held responsible because the Licensee is deemed an agent of the Licensor...and not an independent contractor.

- **Creates Franchise.** Also, the violation of the independent contractor status of the Licensee may throw the structure from a lawful license into an unregistered franchise situation. If the licensee is truly an independent contractor and can do his work in his licensed business in the manner, time, hours, and use of equipment etc. that he chooses, then he will be a licensee. If there is even slightly more control, then Licensee *may* slip into the area of being involved in a franchise, and what Licensee thought was a license arrangement may well be a franchise situation and Licensee is now a franchisor that has not complied with the franchise laws.

The Business Opportunity Statute Issue

- Some States have what are called “Business Opportunity Laws” or “Seller Assisted Marketing Plan” (SAMP) laws. These laws require the registration of certain business opportunities offered in the State. They are of fairly recent vintage, as laws go, and they were created to protect the people against the plethora of fraudulent “business opportunities” that flood the media. The registration usually is not difficult to do, but it may be costly (not as costly as franchising) and time consuming.

- **DEALING WITH THEM!** One offering a business opportunity in these States must either (i) avoid the factual situation that brings one within these laws, (ii) obtain a waiver of these laws in the States where waivers are acceptable, (iii) comply with the requirements of registration, or (iv) use a combination of the above remedies. Check with counsel of the applicable State. The terms of the License Agreement will often determine the path to take with regard to these statutes.

- Except for coin operated machine transactions, at present there is no Federal legislation on business opportunity laws, but for a couple of years now a proposed law has been out circulating for comments from the public. Often the federal Franchise law is applied to business opportunity situations.

“Franchise Statutes” in States that do NOT have Franchise Laws (Or the “New Jersey Stumble”)

Even though there are only fifteen (15) States that have their own franchise laws, some States have what I call “special franchise laws” which are not the California type disclosure and registration statutes. For instance, New Jersey does not have registration and disclosure statutes, but they do have “*The New Jersey Franchise Practices Act*”. This Act calls distributors of good and services “franchisees” for the sole purposes of the Act, and the Act does two primary things: (i) The Act makes it illegal for a manufacturer to terminate or refuse to renew a dealer unless the dealer substantially violated the terms of their agreement, and (ii) the Act also prohibits manufacturers from imposing “unreasonable standards of performance” upon the dealer; i.e. a manufacturer cannot create an unreasonable situation to force a dealer to give up the line. In essence, the Act protects the “franchisee” from unfair terminations or refusals to renew distribution agreements. The point of mentioning this type of law is to point out that even if one avoids the need to comply with the franchise laws of a State or there are no franchise laws in a particular State, there may be laws affecting the distribution of goods/services agreements nonetheless of which one should be aware.

A Synopsis: The Keys to Licensing a Business Opportunity

1. **Create Leverage So Licensee WANTS to Do What Licensor wants.** As the Licensor does not have the legal control over a Licensee that a Franchisor has over a Franchisee, the Licensor must create an environment with the Licensee

where the Licensee wants to voluntarily do what the Licensor desires him to do. For example, the payment of an initial license fee by the Licensee motivates the Licensee to follow the example of the Licensor, as that information is what he is paying for.

2. **Realize that Sometimes You Have to Franchise.** Sometimes a potential Licensor must accept the facts that in some situations using the licensing model in the particular State cannot be done. Sometimes he has to either (a) use a different business model, or (b) register as a franchise.

My approach in preparing license agreements is to (i) have the proposed Licensor prepare a bullet-point of what he wants the Licensee to do each day, (ii) prepare a list of what the Licensor wants to provide to the Licensee, and (iii) prepare a list of how the Licensor is going to get paid by the Licensee. I analyze these three lists and try and shape them into a license agreement with the client compromising to meet the licensing requirements. If there is too much compromise required, then we have to eliminate licensing and do something else, including the possibility referring the client to a franchise lawyer.

HOW TO SELL LICENSES

Introduction to Selling Licenses. Of course the first step is to have a license agreement available for licensees to sign. The license agreement defines your relationship with the licensee, and you cannot even begin to lawfully sell licenses and have a formal relationship without clearly knowing the boundaries agreed to in that written agreement. After establishing your business vision, the first thing to do is to get the license arrangement in writing. But this brings up the issue of, “So I have a license agreement, how do I obtain the licensees that will sign it?” Well, here is how you do it.

The Two Essential Secrets.

Secret #1. Secret Number One to selling business opportunity licenses is for you as the Licensor to be (i) genuine, (ii) likable, and (iii) truthful, because potential licensees that are looking at a business opportunity want two things: (1) a Licensor they like and trust, and (2) an excellent chance to make a profit as a licensee. To be liked and trusted is essential, because no one is going to choose “up front” to spend their time, sweat, and money working with someone they don’t like and don’t trust. Though it may happen, no one will intentionally start out that way. And the key to being a Licensor that is liked and trusted is to have *the genuine* attitude and feeling that the licensees are human beings that deserve your general kindness *and* that you manifest *truthfully* that you want them to make a profit as your licensee. Licensors that are “hard selling” to get the up-front initial license fees and who “down deep” really don’t care how well the licensees do once that initial fee is paid may receive the initial fees, but they don’t build a sustaining licensing business with long term relationships of business kinship and profit (and they usually get sued *or* worse).

Secret #2. The second secret to selling business opportunity licenses is that Licensors don’t sell licenses, licensees do. It is the successful licensee acting as an endorser and reference and giving testimony of success that convinces new potential licensees to become licensees. The licensee-candidate for a license wants to be convinced that *someone else* has done this before and (i) they are successful or (ii) they are new but certain that they are on the road to success. To the licensee-candidate, the Licensor has a built in bias (which he does...he wants to sell a license); on the other hand, the Licensee appears to have no such bias (He is not in the business of selling licenses.) All the reference-licensee has to do is to tell the *truth*. He has no motivation to do otherwise. The licensee-candidate knows this, the *truth* is what he is seeking, and therefore the testimony has great value.

The Marketing Goal. The goal in marketing licenses is to drive the licensee candidate to the unbiased testimony of an existing licensee to confirm all that the candidates need confirmed in order to purchase a license; i.e. someone is doing it and that someone is successful (or they are certain that they are on the road to success). I call this the “reference-licensee”. This is what closes the deal. But please note that it is better not to advertise that there is a reference-licensee that will give

great supporting information to support the sale of a license, as this action by the licensor tends to dramatically diminish the value of such a third party reference. You do not want to advertise a cooperative effort between you and the referral-licensee. You have to wait for *the licensee candidate to ask for a reference*, and then you tell them that getting such a reference is “no problem”. Getting the reference *must be the licensee-candidate’s idea*. And that “idea” always comes up in the conversation...everybody wants to know that someone else has done it and that they are successful, etc. And later your “cooperative relationship” with the reference-licensee will be understood AND appreciated, as the potential licensee candidate observes the evidence that you and your licensees get along just fine (See Secret#1), and they always like that.

Establishing the Reference-Licensee. Knowing that the odds of expanding your business quickly through licensing dramatically increases with the availability of a reference-licensee to help market licenses, the matter arises as to how to establish the “reference-licensee”. Since you have much riding on the success of your first licensee, it is smart for you to put a lot of time and help in getting him/her started. This involvement is important (a) in helping the licensee toward profitability and a potential reference, and equally important (b) you learn much about the licensor-licensee relationship which will be very helpful as your business expands through added licenses. Sometimes it is easier to seek out an initial licensee that is geographically close to you, so that you can more easily spend time at the licensee’s place of business. Friends and relatives are often good candidates to be your initial licensees. Remember that the cost of each license may be different, so in order to get started you may lessen the burden of the start-up license fee and the related costs. You don’t have to charge everyone the same license fee. But if you have to begin with a licensee that is not geographically close, with modern day communications (e.g. video SKYPE), you can still give the needed assistance to your initial licensee. It is important to note that you should not advertise this added assistance in seeking licensee-candidates, as this may take you into the area of a “hidden franchise”.

Finding Potential Licensee-Candidates. In order to have an initial licensee that will work as a reference-licensee, you must in the first place *have* an initial licensee. The “chicken and egg” issue. The first licensee is often the most difficult to obtain, though in over half of my client situations the client has decided to expand its business through licensing because someone has approached them about being a licensee or franchisee. So sometimes it is very easy to get the first licensee. To get the first licensee or all the other licensees you have to start with marketing or as I have always called it, “*Ring the bell to get the people inside the temple.*” (Mixed religion metaphor of a ringing bell on a temple). In my opinion, the best way to do this is through expensive or free advertising. I suggest that you start in Craigslist in a territory that you wish to develop. Do some test advertising; make it work in that particular territory before you expand elsewhere. Don’t take an unsuccessful ad on the road! That is certain failure. Also, note that you can advertise your business opportunity wherever franchisors advertise franchising opportunities. Look at magazine, trade journals, and newspaper classifieds. The costs of these ads vary, and again test the ad in a low cost media before you expand to spending more money. Money should not be the issue. Smart marketing is more important; i.e. targeting your market, finding where the people are in that market, and then give them the right message. Remember that the message is to drive the targeted people ultimately to the referral-licensee. In today’s marketing, that “drive” will usually go through a website that explains the licensing opportunity in such a manner that the licensing-candidate wants more information from you before asking for the referral-licensee. Trade shows are also very good avenues to find potential licensees. If you don’t have the money to get a booth, do hand-outs placed under hotel room doors with invitations to call and meet. Or seek to share a booth. You don’t have to pay a lot of money to market, and ironically, this fact helps you establish a better business.

FREQUENTLY ASKED QUESTIONS

1. ***How about using marketing companies to sell licenses?*** This is one way of doing it. This is how franchises are sold, and licenses can be sold the same way. In this situation a marketing company has commissioned salespeople selling the licenses. In my opinion this is not a very good way of expanding a business. First, the prices of the license have to be raised, because large commissions have to be paid to the sales personnel. You cannot raise money for your own purposes by the payment of the initial license fees, because almost all of this fee goes to the salesperson as a commission (including the company he works for). The other negative of using these companies is that they have little motivation to tell the truth, and they frequently misrepresent the facts when selling the licenses or franchises. The licensee is lead to believe that the salesman is a good guy whom he will be working with when the fact is that the salesman will collect his commission and move on to the next deal. Just the relationship is misleading without going into what is represented.

This results in many lawsuits for misrepresentation. Another drawback is that they usually want a separate fee from you (sometimes a large fee) to set up the sales effort. I prefer the low cost and more long-term effective approached discussed above.

2. ***How do you determine the amount to charge for an initial license fee?*** As a Licensor you should know how much profit (income less expenses) to project for a licensee operating a business that you have licensed. Once you have determined that profit, then ask yourself, “How much would you pay as an upfront license fee to work 60 hours a week, earn this projected amount of gross profit and then pay you a continuing license fee of ten percent?” Test it on some friends. Also remember that different territories have different profit potentials and thus the territories themselves have different values. In marketing licenses one of the factors is the income expectations of your potential licensees. If they expect to make \$200,000 per year and your profit projection indicate a net profit before taxes of \$70,000, then you know who your targeted market is. Not this guy. It is someone who will be satisfied with \$70,000 per year. So you market accordingly. Do not inflate the expectations of profit, as this can only lead to problems which you do not want. If you do the math and the profit potential, the math may dictate that the profit margin after paying a continuing licensing fee may be so small that you may have to sell a *part-time* licensing opportunity, which is a different market altogether. And sometimes the math just doesn’t add up to allow you to expand by using licensing.

(NOTE: I will add new questions and answers from time to time. So check back.)

Attorney Fees: What is this going to Cost the Client?

- Some attorneys charge on an hourly basis while others charge on a flat fee basis. I charge on a flat fee basis, so that the client knows the full extent of the legal bill in advance. In a major city for *knowledgeable attorneys* you should expect to pay between \$10,000 and \$20,000 in legal fees for the legal work to set up a licensing program (**Because of my unique method of practice, my fees are approximately 50-to 70% lower than senior attorneys would charge for the same work in a large law firm in Los Angeles.**) Fees vary from geographical areas and as to the quality of services provided. Whatever the charge, it is far less than franchising fees; e.g when I did franchising work my retainer was \$35,000 and often eventually it went over \$100,000. **Most lawyers have free initial telephone conversation. This is my practice. Find out right away (i) if the client is in the “ballpark” for “Licensing” or some other format and (ii) let the client know what it is going to cost. These are the two things a client wants to know. If the client does not qualify for licensing or some other format other than franchising, I send them to a franchise counsel of their choice. I also can show them how to franchise at substantially less the cost than ordinarily quoted.**

- **Financing Legal Fees.** Sometimes the person who is seeking to set up a licensing situation wants to finance the legal fees to do so. One of the ways to do this is to grant an option to an interested party to buy the licensing right to a territory. The option fee should be enough to get the license agreement prepared. The exercise fee should be the amount of the initial license fee less the option fee. For example, if the person wanted to raise \$10,000 to pay the legal fees to create the license agreement, the option fee would be at least \$10,000. Let’s say that the “initial license fee” under the license agreement is \$20,000. Then the exercise fee would be \$20,000 less the \$10,000 option fee, and thus the initial license fee would be paid for and the legal fees for preparation of a license agreement that will work with other potential licensees is paid for. This is done all the time on a broader scale where for example one may sell the rights to Mexico in order to raise the money to create a marketing operation in the United States.

- **Payment Terms.** Clients often asked if there are payment terms. Some lawyers offer terms and other do not. (I offer limited payment terms based upon the time the client wants the licensing documents delivered for use. This is based on the concept that the people who pay the full fee at the time of signing the retainer should get priority in service.)

Note on Article: The information in the above article is a synopsis of a book that he is writing on the subject of “licensing”, which will be his second book in his “Lawyers’ Guide” Series.

New Book Title:

LAWYERS' GUIDE: Advising Clients on Licensing Versus Franchising
Available in summer of 2010

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• **Education:** Bob Townsend is a graduate of the University of California at Berkeley and the University of California, Hastings College of the Law in San Francisco. He is an active member of the State Bar of California. He has law offices in Los Angeles and as well as a home and office in New Orleans, where he spends a great deal of time these days and is involved in certain Katrina volunteer recovery work in education (setting up a foundation). He also does his legal work from Los Angeles in both California and New Orleans.

• **Legal Experience:** Bob's legal experience involves 20+ years in transactions in nearly all the States and 33 foreign countries. His areas of experience are domestic and international transactions and licensing and the separate field international private securities trading. He has fourteen years experience primarily devoted to business opportunity licensing.



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