

# Did You Draft a License Agreement or Create an Illegal Franchise?

by Carl Khalil and Folafoluwa Soluade, JD Candidate



So, your firm has a local small business client, let's call it "Frosty Ice Cream," and the CEO comes to your law firm excited that he has been approached by an entrepreneur in Arlington who would like to open a Frosty Ice Cream in Northern Virginia.

You say, "No problem," and you whip out a license agreement through which your client will give the third-party entrepreneur the right to use the Frosty name and business system for an outlet in Arlington in exchange for a \$25,000 license fee and a 2 percent royalty on sales. And all seems fine...

**...until you are sued for malpractice because you just furnished to your client an illegal franchise agreement that did not comply with the FTC Franchise Rule and was not registered under Virginia law.**

Here is where you went wrong. Under federal law, a franchise is defined as:

Any continuing commercial relationship or arrangement, *whatever it may be called*, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:

1. The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's **trademark**, or to offer,

sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;

2. The franchisor will exert or has authority to exert a **significant degree of control** over the franchisee's method of operation, or provide **significant assistance** in the franchisee's method of operation; and
3. As a condition of obtaining or commencing operation of the franchise, the franchisee makes a **required payment** or commits to make a required payment to the franchisor or its affiliate.<sup>1</sup>

And "[r]equired payment means all consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise. A required payment does not include payments for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale or lease."<sup>2</sup> The "required payment" element is met with a payment of \$615 or more.<sup>3</sup>

Likewise, under Virginia law, a franchise is similarly defined as:

A written contract or agreement between two or more persons, by which:

1. A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services at retail under a marketing plan or system prescribed in substantial part by a franchisor;
2. The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate; and
3. The franchisee is required to pay, directly or indirectly, a franchise fee of \$500 or more.<sup>4</sup>

As one can plainly see, the license agreement meets all three prongs of either the federal or Virginia test: the company's name is being used by the "Licensee," the substantial assistance or control element is met by giving rights to the business system, and the required payment element is met through the license fee and royalties.

However, when a company offers a franchise, to do so legally, **the company must put together a Franchise Disclosure Document ("FDD") containing 23 required elements and the sample franchise agreement.**<sup>5</sup> Moreover, Virginia law does not allow the offer or sale of a franchise unless the FDD has been filed with the state, reviewed, and approved.<sup>6</sup>

Other states have franchise laws as well. And while this article is not intended as a survey of franchise laws, please note that Maryland is another franchise registration state like Virginia, and if Frosty Ice Cream offers a "License Agreement" to a Maryland resident or to an outlet to be located in Maryland, Frosty would likewise violate Maryland law.<sup>7</sup> States with franchise laws that are broken have the authority to pursue those who have offered or sold franchises in those states without complying with their laws.<sup>8</sup>

Once a client has suffered a fine for an illegal license agreement, the next thing your law firm may hear about is a demand to reimburse them for the fine paid and possibly other harm. So, the next time your small business client comes to you excited about expanding through license agreements, don't whip one up. Instead, make sure the client is receiving

competent assistance to prepare a FDD and comply with state and federal franchise laws. ⚖️

#### Endnotes

- 1 16 CFR Section 436.1(h) (emphasis added).
- 2 16 CFR Section 436.1(s) (emphasis added).
- 3 See 16 CFR Section 436.8(a)(1) (exempting franchisors from disclosure requirements and prohibitions concerning franchising if the total of required payments is less than \$615).
- 4 VA. CODE ANN. § 13.1-559 (2023).
- 5 See 16 CFR Section 436.2 (obligating franchisors to furnish franchisees with disclosure documents); 16 CFR Section 436.4 (listing the 23 required elements in a disclosure document and requiring the document include the franchise agreement); 21 VA. ADMIN. CODE 5-110-55 (2022) (requiring an FDD prepared per federal law).
- 6 VA. CODE ANN. § 13.1-560 (2023) (making it "unlawful for any person to sell or offer to sell a franchise in this Commonwealth unless the franchise is registered . . . or exempted from registration by rule or order of the Commission").
- 7 MD. CODE ANN., BUS. REG. § 14-214 (2023) ("a person must register the offer of a franchise with the Commissioner before the person offers to sell . . . or sells the franchise in the State.").
- 8 See *Virginia, ex rel. State Corp. Comm'n v. Regal Nails, LLC*, 2007 WL 1952494, at \*1 (ordering LLC to pay a penalty and agree not to violate the Virginia Retail Franchising Act in the future); *In re Regal Nails, LLC*, 2006 WL 6825402, at \*2 (ordering Regal Nails to pay costs related to the investigation and to "cease and desist from offering or selling franchises in violation of . . . the registration section" of Washington's franchise act).



**Carl Khalil** is a partner in the Law Offices of Carl Khalil and Sada Sheldon, PLC in Virginia Beach. He has 28 years of franchise law experience and previously worked as Corporate Counsel for Jackson Hewitt and Liberty Tax Service. He may be contacted at (757) 263-4596 or [carl@khalilsheldon.com](mailto:carl@khalilsheldon.com), and his firm's website is at [www.KhalilSheldon.com](http://www.KhalilSheldon.com).



**Folafoluwa Soluade** is a legal intern at the Law Offices of Carl Khalil & Sada Sheldon, PLC and a third-year law student at Regent University School of Law where she also serves as Managing Editor for the *Regent University Law Review*.