

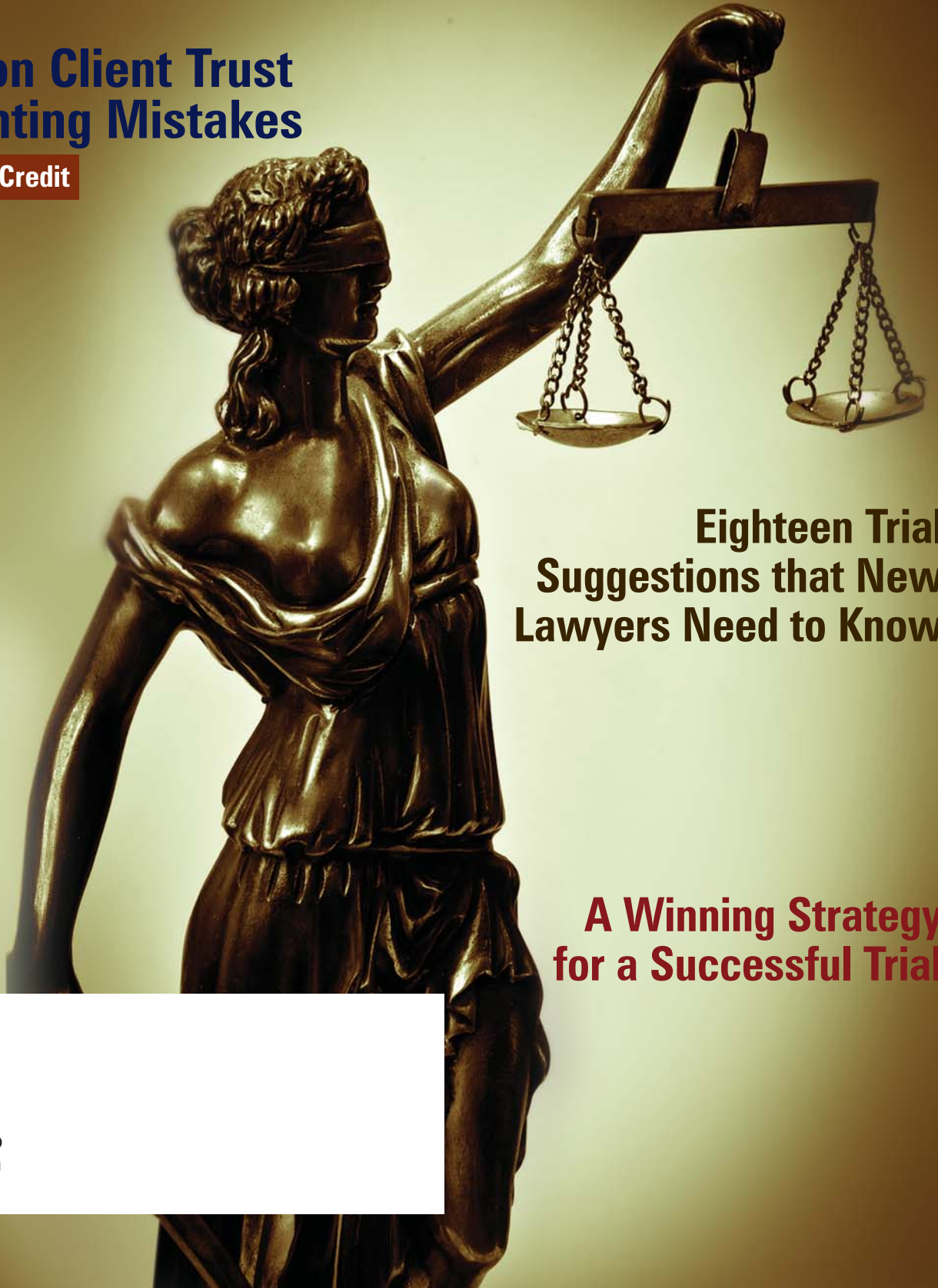
VALLEY LAWYER

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A Publication of the San Fernando Valley Bar Association

Common Client Trust Accounting Mistakes

Earn MCLE Credit



**Eighteen Trial
Suggestions that New
Lawyers Need to Know**

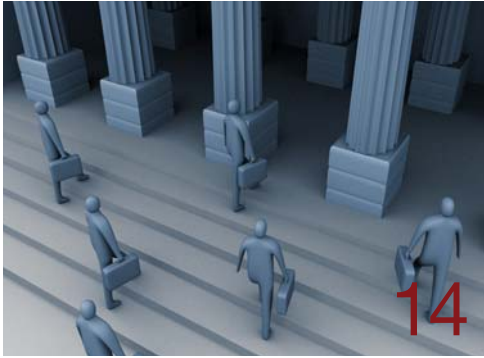
**A Winning Strategy
for a Successful Trial**

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New Lawyers



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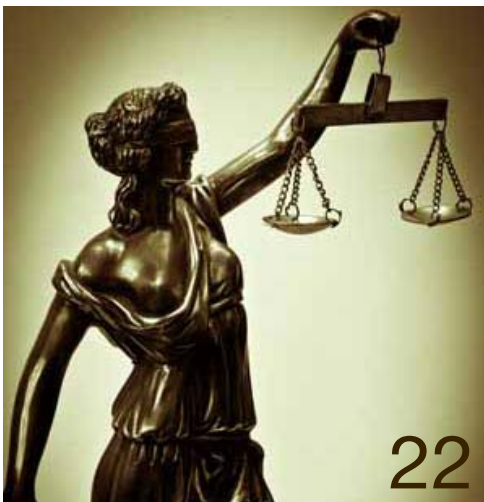
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the franchisees for compliance to protect the integrity of its systems. In typical franchises, franchisees rely on their franchisors for advice, training, advertising and marketing assistance. Furthermore, franchisors usually mandate the use of specific suppliers, and in some cases, even act as the exclusive supplier of certain products or services sold by their franchisees.

Licensing, Distributorships and Dealerships

True licensing, distributorship and dealership arrangements are not franchises because they lack at least one of the three elements defined under California law as described above. For example, under a typical licensing arrangement, one company permits another to sell its products or services in exchange for a percentage of the proceeds without any other involvement on the part of the licensor. In dealership and distributorship arrangements, independent businesses operate under their own trade names. The dealers or distributors usually buy products or services from the other party at wholesale prices and then resell them to the public. Neither party is substantially involved in the business affairs of the other.

Why Not Classify Every Arrangement as a Franchise?

In general, a franchise is a contractual arrangement that makes one party or business dependent upon another. Franchise agreements strongly favor franchisors and are typically written by the franchisor's attorneys; franchisees usually have little power to negotiate favorable terms. While franchise agreements are not considered contracts of adhesion, the Federal Trade Commission, as well as many of the states, have taken the position that these arrangements provide a much greater potential for fraud, which explains why franchises are so highly regulated, and other business relationships are not.

The prospect of registering a franchise can be quite expensive and time consuming. Expansion-minded entrepreneurs or businesspersons typically prefer to streamline the deal process and will push for the simplest, cheapest option. But keep in mind that any combination of the use of a trademark for a fee and the imposition of the trademark owner's operating methods or systems or other direct involvement in the operator's business will make these relationships a franchise. That is why it is crucial for attorneys involved in setting up any of the above mentioned arrangements to determine whether the practices push the relationship into the realm of franchising and explain to their clients the risks related to a mischaracterization of the relationship.

Additional Requirements

Under California's Franchise Investment Law (FIL), it is unlawful to offer or sell a franchise in California unless the offering has been registered with the DOC or it is exempt. If an arrangement satisfies the elements of a franchise under California law as listed above, the franchisor must take on burdens not imposed in licensing, distributorship and dealership arrangements. The franchisor must (1) file a franchise disclosure document with the DOC outlining the franchise opportunity in detail and providing information regarding the franchisor's own background and business experience, among other things, before entering into any discussions with potential franchisees; (2) disclose potential franchisees with its registered disclosure document and wait at least 14 full days before having the franchisee execute any franchise documents or accepting any payments; and (3) obtain DOC approval for any "material modifications" to its registered franchise documents before presenting them to franchisees, including any new or modified provisions regarding royalties, fees, e-commerce, and territorial rights.

Risks of Mischaracterization of the Relationship

The DOC closely polices franchisor-franchisee arrangements and may assess penalties of \$2,500 per violation of the FIL. This apparently modest fine, however, is only part of the story. The DOC also has the authority to require accidental franchisors to provide notice of the violation to all of its franchisees, offer rescission of all contracts related to the franchise and refund payments made by the rescinding franchisees.

As an example, suppose a company enters into purported licensing agreements with several other companies involving trademarked products or services, unaware that the details of the arrangements have actually established franchisor-franchisee relationships. Further suppose that at some point one of the "licensees" who has been losing money discovers the error. If the "licensee" reports the matter to the DOC, the DOC will likely fine the franchisor and require it to offer all of its inadvertent franchisees the right to rescind their original agreements and get their money back. This applies to each franchisee's original investment, as well as any losses, less profits, they may have incurred. Needless to say, if the franchisor wishes to continue conducting the same business it will then need to complete the registration process. This can prove painful, even ruinous to the inadvertent franchisor.

For years, business owners have found franchising to be a highly effective expansion strategy. That said, franchising is a highly complex area of the law that lends itself to specialization. Attorneys representing business owners must be able to spot the telltale signs of a franchise to avoid unwittingly assisting their clients in becoming accidental franchisors. ⚡

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