Revenue Generating Alternatives for Franchises and the Associated Risks

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Franchise brand owners[1] do an excellent job generating revenue from their franchise operations. FRANdata reported in its International Franchise Association 2024 Economic Outlook that, with over 800,000 franchise establishments operating in the United States, franchising, by itself, was responsible for over $850 billion in economic output and supported over eight million jobs.[2]

But do franchisors spend enough time considering other ways to monetize their franchise brands outside the franchise operation? Considering the economic success and popularity of the top franchise brands, one might expect at least one franchise brand to rank among the top global brand licensors. In 2023, however, License Global did not name a single franchise brand in its Top Ten list of Global Licensors.[3] Among the list are notable brand owners like Disney (first), Authentic Brands Group (third), Warner Bros. Discovery (fourth), Hasbro (sixth), and Mattel (eighth), which together accounted for almost $200 billion in licensing revenue.[4] According to the May 22, 2024, Licensing Letter in 2023 "[g]lobal sales for licensing hit a new high . . . of $356 [billion]."[5] Clearly, brand licensing represents a potential for significant revenue growth. In

1. The owner of a franchise system's intellectual property, including its trademarks, may not always be the franchisor of the franchise system. Some systems, for example, create an affiliate that owns all intellectual property and licenses that property to the franchisor, which in turn sublicenses its use to the franchisees. This article uses the term franchisor to describe the franchisor and any affiliate that owns the system's intellectual property interchangeably.

2. Ashley Rogers, Jin Qi & Khadija Cochinwala, *2024 Franchising Economic Outlook*, Int'l Franchise Ass'n (Feb. 14, 2024), https://www.franchise.org/sites/default/files/2024-02/2024%20Franchising%20Economic%20Report.pdf.

3. *The Top Global Licensors Report 2023*, License Glob. (July 27, 2023), https://www.licenseglobal.com/rankings-lists/top-150-leading-licensors.

4. *Id.*

5. Gary Symons, *Study Says Licensed Merch Sales Hits Record $356.5B in 2023*, Licensing Letter (May 22, 2024), https://www.thelicensingletter.com/study-says-licensed-merch-sales-hits-record-356-5b-in-2023.

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addition to the brand itself, franchisors also make use of various patents, trade secrets, and proprietary methods. Opportunities may exist for franchisors to license patents, trade secrets, and other proprietary methodologies. Aside from "straight" intellectual property licensing, franchisors also may consider alternative distribution channels, such as e-commerce, ghost kitchens, concessionaires, and nontraditional locations, to increase revenues. All of these alternatives, however, increase the risk of claims for encroachment, unfair competition, or breach of the franchise agreement.

This article examines these revenue generating alternatives for franchisors, along with their accompanying risks. Part I discusses traditional licensing, including technology and brand licensing. Part II focuses on revenue-generating alternative distribution channels. Part III analyzes the challenges franchisors may encounter adopting alternative distribution channels.

I. Traditional Licensing

Traditional licensing is a natural fit for franchisors to generate additional revenue. Similar to how franchise agreements allow other businesses to duplicate the franchisor's business across numerous locations, traditional license agreements allow other businesses to use the franchisor's brands or proprietary business methods or to sell the franchisor's products or services outside the franchised businesses.[6] Through these licensing arrangements, franchise brands may increase their marketplace exposure, elevate their brand awareness, and monetize their assets in a way that does not compete with their existing franchise business.[7] In fact, such alternative licensing may increase business for the franchise operation.[8]

Traditional licenses fall into two broad categories: (i) licenses for technology and know-how and (ii) brand or trademark licenses.[9] The risks to franchisors from such licensing activity outside the franchise relationship depends on the scope of the license granted and whether such license avoids competing—directly or indirectly—with existing franchise businesses. This article considers each category in turn.

A. *Technology and Know-How Licensing*

A franchisor may own proprietary technology, and sometimes even several patents on the methods by which its franchisees operate the franchise.[10]

6. This can also work in the reverse where franchisors license to sell other brands' products through co-branding or collaboration.

7. For example, McDonald's has hired IMG, a top licensing agency, to "develop a wide range of licensed products and experiences globally, to build the brand, and drive its growth on a global basis." Symons, *supra* note 5.

8. *Id.*

9. *See generally* David A. Beyer, *Considerations in the Development of a Franchise System*, Franchise L. & Prac. (1996).

10. *See* 16 C.F.R. § 436(n) (requiring franchisors to disclose whether they own rights in or licenses to patents or copyrights that are material to the franchise).

Generally, franchise agreements with franchisees do not preclude the franchisor from licensing its technology assets to third parties outside the franchise operation.[11] Such a license may allow the franchisor to enjoy a revenue stream in the form of licensee royalty payments, while avoiding the costs associated with developing or manufacturing the licensed product or service.[12] Unlike the franchise relationship, in return for the license income stream and reduced costs, the franchisor does forgo some degree of control over the licensee's business in selling the licensed products or services and because the franchisor is not making and selling the licensed product or service to the market itself, it loses out on a portion of the downstream revenue that the product or service generates for the licensee.[13]

In the franchise context, a technology license makes sense where the franchisor owns patents or other intellectual property, like trade secrets, relating to methods for doing business that may apply to industries other than the one in which the franchise operates. Examples of such patents or intellectual property include point-of-sale systems, customer relationship management tools, or other industry-specific software. Licensing this technology should not increase the risk to the franchisor of any claim for breach of the franchise agreement because such activity could take place outside the franchise operation in non-competing areas of the marketplace.

Consider a restaurant franchisor that has developed intellectual property around food preparation, packaging, or shipment. Although the franchise businesses only serve hot food to consumers in physical restaurant locations, the franchisor's technology and know-how may have equal application in the consumer packaged-foods business directed to grocery stores or other retail food store locations. By licensing its technology, the franchisor monetizes its existing technology with third-party businesses that are in the packaged foods space and will use that technology without increasing competition for the franchisor's principal franchise restaurant business. A technology license like this brings little risk to the franchisor due to the non-competitive nature of the licensee's use of the licensed technology.

This analysis, of course, assumes that the licensee's use of the licensed technology will not hurt franchisee sales. If, however, a restaurant franchisor allows third parties to sell competing food products in local supermarkets, and consumers suddenly stop visiting the franchised restaurant locations, the franchisor may risk claims for encroachment, unfair competition, breach of contract, or lack of good faith from its franchisees.[14] Limiting the license to use for products that are not sold by the franchised businesses may further mitigate this risk. Similarly, terms in the franchising agreement allowing for such conduct will also reduce the risk.

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11. Beyer, *supra* note 9, § 2.24.
12. *Id.*
13. *Id.*
14. *See* discussion *infra* Part III.B.

For example, in the past year McDonald's has filed several patent applications with the U.S. Patent and Trademark Office in connection with its development of goods and services in the metaverse.[15] In addition to using these patents in connection with the metaverse, McDonald's ultimately may use any patents that it obtains to support its franchised restaurants in the real world.[16] McDonald's also may decide to license its technology to non-competitor businesses, like clothing retailers, to conduct business in the metaverse. Franchisors can license other technology, like proprietary business methods and trade secrets, in the same manner, provided that all licensees are obligated to maintain the trade secret as confidential.[17]

B. *Brand Licensing*

Every franchise agreement involves a trademark license to a franchisee to use those trademarks in connection with operating the franchised business.[18] But, as noted earlier, there is usually nothing in any franchise agreement precluding the franchisor from licensing its trademarks in a variety of ways that do not compete with the franchised businesses.[19] In a typical franchise relationship, the franchisor licenses its trademark in exchange for royalties or other fees and, to maintain brand standards, exerts necessary control over the franchisee's business operations.[20] Franchisors willing to consider alternative brand licensing arrangements may find lucrative opportunities to license their trademarks to franchisees or non-franchisees for co-branding, collaborations, or partnerships with celebrities, influencers, or other brands, all of which may increase a franchise brand's exposure and potentially drive alternative non-franchisee revenue to a franchisor.

From a brand owner's perspective, collaborations provide an attractive option for launching new products, and they also generate hype, often without paid advertising. Moreover, brand licensing provides consumers the opportunity to show their loyalty to their favorite brands and their licensed partners, as well as introduce new customers to the collaborating brands. For example, Krispy Kreme recently teamed up with celebrity Dolly Parton to

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15. Gary Symons, *McDonalds Files Patents for its Launch into the McMetaverse*, Licensing Letter (Feb. 16, 2022), https://www.thelicensingletter.com/mcdonalds-files-patents-for-its-launch-into-the-mcmetaverse.

16. *See generally* Marc A. Lieberstein & Robert Potter, *Franchising in the Metaverse*, N.Y.L.J. (Feb. 22, 2022), https://www.law.com/newyorklawjournal/2022/02/22/franchising-in-the-metaverse.

17. CAE Integrated, L.L.C. v. Moov Techs., Inc., 44 F.4th 257, 262 (5th Cir. 2022) ("A trade secret is information which derives independent economic value from being not generally known or readily ascertainable through proper means.").

18. *See* 16 C.F.R. § 436.1(h)(1) (defining franchise to include commercial relationships where the franchisee, among other things, "[w]ill obtain the right to operate a business that is identified or associated with the franchisor's trademark").

19. Beyer, *supra* note 9, § 2.25; Lisa Pearson & Marc Lieberstein, *Brand x Brand: Collabs and Cobranding*, Licensing J., Sept. 2021, at 1.

20. 16 C.F.R. § 436.1(h)(2) (defining franchise to include commercial relationships where the franchisor, among other things, "[w]ill exert or has authority to exert a significant degree of control over the franchisee's method of operation").

release the Dolly Southern Sweets Doughnut Collection comprising four limited-edition doughnuts with unique names like the "Dolly Dazzler."[21] To encourage visits to franchise businesses on the launch day, Krispy Kreme offered a free doughnut to anyone willing to dress up as Dolly Parton or sing her songs in-store.[22]

In another brand collaboration, Dunkin' partnered with TikTok's most followed star at the time, Charli D'Amelio, to add her go-to coffee order, "The Charli," to the menu at all locations and on the Dunkin' app. [23] The Charli spurred a twenty percent overall sales boost for cold brews the day it was released, a forty-five percent increase the following day, and a fifty-seven percent increase in app downloads.[24] One year later, the collaboration continued with a limited-edition Charli x Dunkin' merchandise collection available exclusively through Dunkin'.[25] Products included a tumbler, a cold brew tap, and apparel emblazoned with the Dunkin' logo and color scheme.[26]

Dunkin' has continued to expand its merchandise sales through collaborations with celebrity endorsers. A recent Super Bowl advertisement featured the "DunKings," a fictional boyband including celebrities Ben Affleck, Matt Damon, and Tom Brady donning Dunkin'-branded track suits.[27] The day after the advertisement aired, Dunkin' listed DunKings merchandise for sale on its website, complete with the tracksuit, a bucket hat, and a tumbler.[28] The merchandise sold out within nineteen minutes and became the "fastest collection to sell out in Dunkin' history," according to a company spokesperson.[29]

Brand licensing is not limited to quick service restaurants. In partnership with Sony Pictures during the release of The Garfield Movie, Motel 6 designed Garfield-themed rooms available at ten Motel 6 locations complete with orange bedspreads, pizza-themed bedding, and mini fridges stocked with lasagna.[30]

These collaborations quantifiably benefit franchisors by generating alternative revenue for the franchisor or increasing sales at franchised locations.

21. Liv Weller, *Krispy Kreme®, Global Superstar Dolly Parton Partner for All-New 'Southern Sweets' Doughnut Collection*, Bus. Wire (May 14, 2024), https://www.businesswire.com/news/home/20240514987299/en/KRISPY-KREME%C2%AE-Global-Superstar-Dolly-Parton-Partner-for-All-New-Southern-Sweets-Doughnut-Collection.

22. *Id.*

23. *Calculating Charli D'Amelio's Massive Sales Lift for Dunkin'—StatSocial Influencer Attribution Use Case*, StatSocial (Nov. 11, 2020), https://www.statsocial.com/charli-damelio-dunkin-influencer-attribution.

24. *Id.*

25. Press Release, Dunkin', Sip in Style with the Charli X Dunkin' Merch Collection (Mar. 29, 2021), https://news.dunkindonuts.com/news/charli-dunkin-merch.

26. *Id.*

27. Katelyn Umholtz, *Here's How to Get Ben Affleck's Dunkin' Swag from Sunday's Super Bowl Ad*, Boston.com (Feb. 12, 2024), https://www.boston.com/news/entertainment/2024/02/12/dunkin-tracksuits-ben-affleck-dunkings-super-bowl-ad.

28. *Id.*

29. *Id.*

30. Press Release, G6 Hospitality, Motel 6 Appoints Garfield as First Ever Chief Pet Officer (Apr. 26, 2024), https://g6hospitality.com/motel-6-appoints-garfield-as-first-ever-chief-pet-officer.

They also increase brand recognition and goodwill. The chart below provides a summary of different alternative revenue generating programs (along with examples) available to franchisors across different industries based on the author's experience:

Alternative Revenue Concepts

Franchise Category	
Business services	Franchisor executing on its reservation of rights to operate in non-traditional locations, e.g., pop-up stores; malls; airports; producing and selling books, e-books, guides, or magazines related to the brand's industry; monetizing a blog, YouTube channel, or podcast related to the brand's industry through advertising and sponsorships.
Commercial and residential services	Via brand licensing, e.g., cleaning or janitorial franchise releasing its own cleaning products line.[31]
Lodging	Hotel brands partner with coffee brands, bath/body care brands, and even food/beverage brands (fractional franchise with a restaurant operating out of the hotel); hotel brands collaborating with entertainment brands to create a themed stay or lodging experience.[32]
Personal services	Via brand licensing or co-branding/collaborations: salons expand to offer branded haircare or beauty products through traditional retail channels;[33] fitness studios offer branded athletic apparel or gear.[34]

31. Carpet and upholstery cleaning franchise Chem-Dry sells branded carpet deodorizer and spot remover. *See Professional Carpet Cleaning Products*, ChemDry, https://www.chemdry.com/products-tips (last visited July 11, 2024).

32. Press Release, *supra* note 30.

33. In 2013, salon franchise Drybar launched a hair product line to be sold exclusively at Sephora, QVC, and Drybar locations nationwide. *See Drybar Launches Product Line; Appoints Two New Senior Execs*, PR Newswire (Jan. 3, 2013), https://www.prnewswire.com/news-releases/drybar-launches-product-line-appoints-two-new-senior-execs-185532952.html. As of 2024, Nordstrom, Ulta and Macy's also carry the product line, which has grown from sixteen to fifty-two hair products and tools. *Id.*

34. Weight Watchers partnered with the Traces wine brand to create a range of low-calorie, low sugar, vegan, and gluten-free wines. *See* Allison Watkinson, *Forget Diet Soda: Weight-Watchers Offers 'Diet Wine*,' Licensing Letter (May 30, 2024), https://www.thelicensingletter.com/traces-named-weightwatchers-uk-wine-partner.

Franchise Category	Alternative Revenue Concepts
Quick service restaurants (QSRs), retail food, products, and services, and table/full-service restaurants	Via brand licensing or co-branding/collaborations: developing a line of branded consumer-packaged goods/frozen food for sale in supermarkets/grocery stores;[35] pop-up locations and ghost kitchens (delivery-only alternative); expansion to luxury level location with influencer or celebrity; non-traditional locations: stadium concessions.[36]
Real estate	Using co-branding options with suppliers to the real estate market, e.g., construction contractors, real estate developers; offering branded e-commerce alternatives to real estate service providers in the area of loans, mortgages, title clearance; creating membership/loyalty programs offering special benefits, discounts, or services in exchange for a recurring membership fee.

II. Alternative Revenue Generating Distribution Channels

Beyond licensing arrangements, a franchisor may look to augment its revenue by selling its branded products or services through alternative distribution channels. These channels run the gamut from corporate-owned stores to e-commerce to so-called "ghost kitchens." Although franchisors may avail themselves of any number of distribution channels—the avenues available to the franchisor are limited only by the franchisor's creativity and, in some cases, the terms of the franchise agreement—one usually finds the alternative distribution channels in the franchisor's reservation of rights section for "non-traditional locations."[37]

A. *E-Commerce and Ghost Kitchens*

No post-pandemic discussion of franchise distribution channels would be complete without mentioning e-commerce and the many permutations of

35. TGI Fridays partners with Kraft Heinz to sell TGI Fridays-branded frozen appetizers for retail distribution. *See* Allison Watkinson, *TGI Fridays Signs Critical Deal with Long-Time Partner Kraft Heinz*, Licensing Letter (May 3, 2024), https://www.thelicensingletter.com/tgi-fridays-signs-critical-deal-with-long-time-partner-kraft-heinz.

36. As of 2018, franchise brand Tim Hortons was the top chain restaurant brand sold in NHL arenas with a presence in seven arenas. *See* Daniel Roberts, *Top Food Chains in Sports Arenas: Dippin' Dots, Papa John's Dominate*, Yahoo Fin. (Jan. 11, 2018), https://finance.yahoo.com/news/top-food-chains-sports-arenas-dippin-dots-papa-johns dominate-194713807.html.

37. *See* Jennifer Dolman, Scott Korzenowski & Erik Wulff, *STOP INVADING MY SPACE: Encroachment Issues in Franchising*, 51st Ann. Int'l Franchise Ass'n Legal Symposium, at 20 (2018) (identifying "non-franchised stores" and "non-traditional or seasonal locations" as potential alternative distribution channels); *see also* Thomas R. Ayres, *Bricks to Clicks: The Post-Pandemic E-Commerce Reckoning*, 41 Franchise L.J. 23, 24 (2021) (analyzing issues created by the increased prominence of e-commerce and digital distribution channels); James B. Egle & Isaac S. Brodkey, *Encroachment in the Era of Digital Delivery Platforms: Impact of Delivery Apps on Brick and Mortar Exclusive Territories*, 41 Franchise L.J. 195, 202 (2021) (identifying "third-party delivery services" as an additional alternative distribution channel).

digital distribution.[38] Two factors have propelled the rise of e-commerce. First, the increased consumer demand for the convenience and efficiency of online ordering and expedited delivery.[39] Online retail continues to eat into the share of total retail sales in the United States,[40] and franchise systems are not immune to this sea change in consumer preference.[41]

Second, the COVID-19 pandemic and resulting shutdowns pushed customers from dining rooms to drive-throughs and from in-person shopping to at-home delivery.[42] These changes cannot be separated from the hybrid work environment that has come to dominate for business professionals, white-collar employees, and other workers whose primary tool in their employment is their computer. Today's consumer can go to work, attend an exercise class, shop for groceries, and pick up dinner, all without stepping off their front porch.[43]

Franchises can take advantage of the increased prominence of e-commerce in a number of ways. For instance, franchises can improve the brand experience for their customers by creating e-commerce infrastructure that effectively serves as a one-stop shop for all things related to the franchise system.[44] An online-ordering portal, with options for delivery or curbside pick-up, can help franchises secure business from their customers. Franchisors also can incentivize franchisees to partner with delivery services like DoorDash, UberEats, or PostMates to help retain online-ordering market share. And, in the same vein, food and beverage franchises can use "ghost kitchens" or next-gen store designs to improve the delivery experience for consumers. [45]

Ghost kitchens are brick-and-mortar locations consisting of little more than a commercial kitchen.[46] The premises are optimized for online orders: there is no storefront, no dining room, and no need for a high-rent location in a heavily-trafficked area.[47] Indeed, ghost kitchens frequently are located

38. *See* Ayres, *supra* note 37, at 24–25 (discussing the explosion of "the use of e-commerce in various franchise models" following the advent of the COVID-19 pandemic).

39. Dolman, *supra* note 37, at 13–14 (discussing "the ongoing evolution and disruption of the retail market, both online and in physical outlets, resulting from increased e-commerce and convergence in the marketplace").

40. Melissa Repko, *Walmart Is Using Its Thousands of Stores to Battle Amazon for E-commerce Market Share*, CNBC (June 2, 2022), https://www.cnbc.com/2022/06/02/walmart-bets-its-stores-will-give-it-an-edge-in-amazon-e-commerce-duel.html. In fact, CNBC has reported that "consumers spent more money at Amazon than the big-box retailer [Wal-Mart] for the first time" in "the 12-month period from June 2020 to June 2021." *Id.*

41. Dolman, *supra* note 37, at 14 ("Franchise systems, in particular, stand to benefit from leveraging a diversified e-commerce strategy that builds a brand name online and leverages physical stores to reach online customers.").

42. *See generally* Ayres, *supra* note 37, at 23–24.

43. *Id.*

44. *See* Dolman, *supra* note 37, at 14.

45. Viggnesh Kandasamy, *How Are Ghost Kitchens Evolving Post-Pandemic?*, Forbes (Sept. 20, 2022), https://www.forbes.com/sites/forbestechcouncil/2022/09/20/how-are-ghost-kitchens-evolving-post-pandemic/?sh=198f387d55e5.

46. *Id.*

47. *Id.*

in industrial areas or other locations typically hostile to profitable in-person dining businesses.[48] As a business concept, ghost kitchens can take many forms. Some are simply converted restaurants, with the dining room closed and all sales made on a to-go basis or by drive-through orders.[49] Others are purpose-built for online orders only, with no public accommodations beyond a lobby or pick-up window for delivery drivers.[50] And others marry a king-sized kitchen with a pint-sized dining area, such as in food halls or other shared spaces, and seek to serve dine-in and carry-out customers alike.[51]

Ghost kitchens create revenue-generating business opportunities for both franchisees and franchisors. A franchisee may agree to open a franchised ghost kitchen, avoiding the time and expense associated with a branded trade-dressed dining room. Although the franchisee takes on the risk of operating a business entirely reliant on online ordering, in return the business would not shoulder the costs of building, cleaning, and maintaining a customer-facing space. Similarly, a franchisor could diversify its revenue streams by opening a corporate-operated ghost kitchen if it reserved these rights in its franchise agreement.[52]

This strategy makes particular sense for multi-brand franchisors, which can use a single kitchen to fulfill orders placed with multiple franchises. For instance, Inspire Brands opened a ghost kitchen in Atlanta to fulfill online orders for pick-up and delivery of food sold under the Arby's, Buffalo Wild Wings, Jimmy John's, and Sonic brands.[53]

Beware, however that franchisees may claim encroachment based on a franchisor operating a ghost kitchen or offering competitive goods or services through alternative distribution channels (even if reserved in the franchise agreement) near a franchisee location.[54] Moreover, although ghost kitchens seemed a perfect way for franchises to adapt to increased consumer demand, including consumer technological reliance, their effectiveness has decreased in the pandemic's wake because indoor dining has resumed some of its frequency, resulting in large franchise brands struggling to maintain delivery-only ghost kitchens or virtual brands alongside service for in-person diners.[55] The influx of clandestine "restaurant" options on delivery apps like Uber Eats has also confused consumers and led to food quality issues as delivery drivers are often dropping off multiple orders in one trip.[56] Uber

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.*

52. *See* discussion *infra* Part III.B

53. *Inspire Brands Launches Alliance Kitchen, the First-of-Its-Kind Kitchen for Delivery and Take-Out Orders in Atlanta*, Inspire Brands (Nov. 9, 2021), https://stories.inspirebrands.com/inspire-brands-launches-alliance-kitchen-ghost-kitchen-delivery-takeout-atlanta.

54. *See* Part discussion *infra* Part III.B.

55. Julie Creswell, *Ghost Kitchens Are Disappearing, Squeezed by Demand and Complaints*, N.Y. Times (Apr. 15, 2024), https://www.nytimes.com/2024/04/12/business/ghost-kitchens-restaurants-pandemic.html.

56. *Id.*

Eats removed 8,000 "storefronts" from its listings last year in response to these complaints,[57] and franchisors are following suit by eliminating or scaling down their plans for ghost kitchens.[58]

This change illustrates another risk with attempting to use alternative revenue generating distribution channels. Putting aside the risk of failure of the channel to work or gain acceptance, the franchise brand could suffer a negative reaction in the marketplace that hurts franchisee sales and harms the brand's value and goodwill.

As franchisors like Wendy's and Applebee's pivot from substantial ghost kitchen investments to increased focus on harmonizing in-store and to-go dining,[59] Wendy's Global Next Gen restaurant design could be instructive for alternative efficient service in the digitized world. Unveiled in 2022, the design plan "streamlines the experience for digital and delivery customers, unlocking up to 400 times the digital capacity of previous restaurant designs."[60] Over 200 Wendy's locations throughout 2024 will implement innovations like dedicated parking spots and walk-up windows for delivery drivers, self-order kiosks to simplify the ordering experience, and a galley kitchen design that runs from each store's front to back to support faster order fulfillment.[61] Popeyes is also re-vamping its kitchens through "easy-to-run kitchen conversions" as a response to "digital becoming a more meaningful channel."[62]

Another more recent alternative revenue generating (cost saving) distribution method lies in the increased use of non-human automation to operate the franchise location. McDonald's and another new burger chain in California, CaliExpress, among others, are opening freestanding kiosks and other forms of automated locations and are rolling such automated restaurants out to take orders, cook, and deliver food. [63] AI is also playing a role in

57. Nancy Luna, *'Ghost' Menu Massacre: Virtual Brands Face a Reckoning as Uber Eats Slashes 8,000 from Its App*, Bus. Insider (July 13, 2023), https://www.businessinsider.com/uber-eats-cuts-8000-virtual-restaurant-brands-2023-7.

58. Last year, Kroger severed a three-year partnership with ghost kitchen firm Kitchen United and closed all eight of its virtual food courts established within Kroger locations across the United States. *See* Catherine Douglas Moran & Aneurin Canham-Clyne, *Kroger, Kitchen United Shutter In-Store Ghost Kitchens*, Grocery Dive (Nov. 28, 2023), https://www.grocerydive.com/news/kroger-kitchen-united-shutter-in-store-ghost-kitchens/700933.

59. *See* Joanna Fantozzi, *Wendy's and More Restaurant Brands Are Moving Away from the Ghost Kitchen Model*, Nation's Rest. News (Mar. 20, 2023), https://www.nrn.com/quick-service/wendy-s-and-more-restaurant-brands-are-moving-away-ghost-kitchen-model.

60. *Wendy's Newest Restaurant Design for the Digital* Age, Wendy's (Aug. 15, 2023), https://www.wendys.com/blog/wendys-newest-restaurant-design-innovation.

61. *See* Ron Ruggless, *Wendy's Offers Digital-Focused Next Gen Design Standard*, Nation's Rest. News (Aug. 17, 2022), https://www.nrn.com/quick-service/wendy-s-offers-digital-focused-next-gen-design-standard.

62. Alicia Kelso, *Popeye's Is Making 30 'Distinct Changes' in Its Kitchen*, Nation's Rest. News (June 5, 2024), https://www.nrn.com/operations/popeyes-making-30-distinct-changes-its-kitchen ("Franchisees have shown a lot of interest . . . . [T]he main benefit is an improvement for team members, which should translate to a better guest experience through higher accuracy and faster speed.").

63. NBC News, *Robots Cook Your Burger and Fries at this New California Fast Food Restaurant*, YouTube (Apr. 13, 2024), https://www.youtube.com/watch?v=MKmuaxHL688; Techly Reports,

creating new efficiencies for franchise businesses, saving on employee and supply costs.[64] Franchisors who invest in these new technological alternative distribution channels for their franchise products and services may see increased profits via increased costs savings.

B. *Concessionaires and Non-Traditional Locations*

In addition, franchises may seek to sell their products or services at nontraditional locations, ranging from concession stands to department stores. These locations may be franchised, such as units in universities, military bases, workplaces, and expositions.[65] Or they may be non-franchised locations like kiosks, locations at airports and stadiums, or locations inside department stores, grocery stores, hotels, pharmacies, and convenience stores.[66]

Nontraditional locations can grant access to valuable captive audiences. If one of the 78,000 fans in attendance at Mercedes-Benz Stadium in Atlanta wants a chicken sandwich, for instance, the in-stadium Chick-fil-A is the only game in town.[67] Moreover, operating a nontraditional location or utilizing new delivery technology allows franchises to meet customers where they are—much like ghost kitchens and e-commerce. [68]

An added benefit to such non-traditional location expansion is that a franchisor may be able to avoid the franchise registration and disclosure obligations if the proposed operator for such location fits within one of the franchise exemptions available under state or federal law. The typical exemption that is often available in this situation is the large franchisee exemption because usually the experienced operators for such non-traditional locations are well-capitalized and exceed the net worth threshold of $6,165,500.[69]

III. Risks of Adopting Alternative Revenue Streams

A franchisor seeking to diversify its income streams faces various risks along the way. One of the more significant risks is that license agreements can result in "accidental franchises," where the business relationship qualifies as a franchise under federal or state law despite the parties' intention to create

Inside McDonald's First Robotic Restaurant | The Future of Fast Food, YouTube (Mar. 11, 2023), https://www.youtube.com/watch?v=29a4pFgBpeY.

64. *Id.*

65. Dolman, *supra* note 37, at 20.

66. *Id.*

67. Sean Ward, *Why Is There a Chick-fil-A in Mercedes-Benz Stadium?*, Chick-Fil-A (Dec. 22, 2017)-, www.chick-fil-a.com/stories/inside-chick-fil-a/why-is-there-a-chick-fil-a-in-mercedes-benz-stadium ("[Franchisee Jonathan] Hollis and his team serve so many guests during each event that they begin preparing nearly four hours before stadium doors open.").

68. In this respect, operating a non-traditional location is much like operating a ghost kitchen. *See* discussion *supra* Part II.A. In both endeavors, the franchise looks outside the box to fit customer preferences by employing an alternative distribution method.

69. 16 C.F.R. § 436.8.

a different relationship. Accidental franchises create compliance headaches and regulatory exposure for the franchisor.[70]

Franchisees also may bristle at the franchisor's efforts to increase revenue through alternative channels. Disgruntled franchisees may claim encroachment based on e-commerce or other digital operations, particularly when the goods or services offered through such alternative channels are competing with those offered by the franchisees. Franchisees may also claim that the franchisor is acting in bad faith or competing unfairly if its pursuit of alternative revenue sources somehow undermines franchisee operations.

A. *The Accidental Franchise*

Businesses are sometimes surprised to learn that an otherwise straightforward contractual relationship actually qualifies as a franchise under state or federal law.[71] Franchise laws cannot be waived, so a franchise may arise even if the parties expressly agree that their venture does not qualify as a franchise.[72] As a result, a franchisor that seeks to generate non-franchise income must scrutinize the franchise definitions under the Federal Trade Commission Rule on Franchising (FTC Rule) and applicable state law to ensure that its new alternative ventures do not qualify as franchises.[73]

Under the FTC Rule, a franchise arises if (1) the franchisee licenses or uses the franchisor's trademark; (2) the franchisor exerts significant control over, or provides significant assistance in, the franchisee's operations; and (3) the franchisee pays more than a designated amount in fees before or during the first six months of the franchise's operation.[74] State laws generally track the FTC Rule, although at least New York is an exception as its franchise law definition merely requires two elements: a trademark license and a fee; *or* a marketing plan and a fee.[75] In other states, the federal definition's second element, which tests control and assistance, is substituted with requirements for a marketing plan or a shared "community of interest" between the franchisor and franchisee in the marketing of goods or services, or an ongoing financial interest in the franchisee's business or the sale of the franchisor's goods or services.[76]

An example of a ostensible distributor relationship turning into a franchise relationship is found in *Major Brands, Inc. v. Mast-Jagermeister US, Inc.*,

70. *See, e.g.*, Megan B. Center, *Accidental Franchises: It Takes a Community (of Interest)*, 39 Franchise L.J. 545 (2020) (discussing accidental franchises).

71. *See, e.g.*, Paul R. Fransway, *Traversing the Minefield: Recent Developments Relating to Accidental Franchises*, 37 Franchise L.J. 217 (2017); Rupert M. Barkoff, *New York Franchise Act: Out in Left Field*, N.Y.L.J. (May 1, 2012).

72. *E.g.*, Safe Step Walk in Tub Co. v. CKH Indus., Inc., 242 F. Supp. 3d 245, 258 (S.D.N.Y. 2017) (finding licensee-licensor relationship "may plausibly constitute a franchisor-franchisee relationship under the FTC Rule").

73. The FTC Rule is codified at 16 C.F.R. §§ 436, 437.

74. 16 C.F.R. §§ 436.1(h), 436.8(a)(1).

75. Fransway, *supra* note 71, at 219–20; N.Y. Gen. Bus. Law § 681(3).

76. Fransway, *supra* note 71, at 219–20; *see* Major Brands, Inc. v. Mast-Jagermeister US, Inc., 2022 WL 3585605, at *2 (E.D. Mo. Aug. 22, 2022) (citing Mo. Rev. Stat. § 407.400).

where the court examined the "community of interest" factor for a Missouri-based relationship.[77] Applying the Third Circuit's guidance on whether a franchise exists under the New Jersey franchise statute, the court found a community of interest in support of a franchise relationship because the distributor had invested in and played a prominent role in marketing the product in Missouri, hired and trained an employee solely dedicated to selling the product, and sent two dollars to Jagermeister per case of product sold.[78]

In addition to the control element, accidental franchises can arise due to disguised franchise fees in a distribution agreement. Courts often find franchise fees in unexpected places. In *To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift America, Inc.*, for instance, the district court found that payments to the manufacturer for its "sales and service publications"—totaling some $1,600 over a nine-year period—qualified as a franchise fee.[79] The Seventh Circuit affirmed, holding such payments brought the distributorship under the "sweeping" definition of a franchise under Illinois law.[80] And in *Wright-Moore Corp. v. Ricoh Corp.*, the Seventh Circuit affirmed the district court's denial of summary judgment to a manufacturer that required its distributor to maintain an allegedly excessive level of inventory.[81] The appellate court reasoned that, even though Indiana's franchise statute "expressly states that franchise fees do not include 'the purchase or agreement to purchase goods at a bona fide wholesale price,'" the cost of acquiring excess inventory can qualify as a franchise fee under certain circumstances, such as where the manufacturer requires its distributors to buy a quantity of goods "so unreasonably large that it is illiquid."[82]

The FTC Rule definitions and its state equivalents stand in tension with the trademark concept of "naked licensing," under which a trademark is deemed abandoned if licensed without restrictions on quality control as necessary to preserve the mark's image.[83] Too little control and the trademark

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77. *See Major Brands*, 2022 WL 3585605, at *2.
78. *See id.* at *3.
79. To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc., 152 F.3d 658, 663 (7th Cir. 1998).
80. *Id.* at 662, 664.
81. Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128, 135–36 (7th Cir. 1990) (applying Indiana law).
82. *Id.*
83. Broeg v. Duchaine, 67 N.E.2d 466, 467–68 (Mass. 1946) (uncontrolled licensing may result in trademark ceasing to have any meaning); Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358, 367 (2d Cir. 1959) ("The Lanham Act clearly carries forward the view of these latter cases that controlled licensing does not work an abandonment of the licensor's registration, while a system of naked licensing does . . . . [U]nless the licensor exercises supervision and control over the operations of its licensees the risk that the public will be unwittingly deceived will be increased. . . ."); Heaton Distrib. Co. v. Union Tank Car Co., 387 F.2d 477, 485 (8th Cir. 1967) ("The generally accepted meaning of 'uncontrolled licensing' is where a trademark owner has licensed someone else to make or manufacture its products and then fails to control the quality of the products made by the licensee, thus permitting a deception of the public."); Barcamerica Int'l USA Trust v. Tyfield Imps., Inc., 289 F.3d 589, 596 (9th Cir. 2002) ("[W]here the licensor fails to exercise adequate quality control over the licensee, 'a court may find that the trademark owner has abandoned the trademark, in which case the owner would be estopped

owner may lose its trademark altogether; too much control and the license may accidentally create a franchise relationship. Although naked licensing and accidental franchising seem to require would-be licensors to walk a precarious tightrope, in practice brand license agreements alone rarely create franchise relationships, as the two doctrines look to different levels and types of control. Under the FTC Rule, "significant" control includes site approval and design or appearance requirements; designated hours of operation, production techniques, or accounting practices; required personnel policies or promotional campaigns; and restrictions on customers.[84] In addition, training programs or operating manuals, management advice, and use of systemwide networks or a website all indicate "significant assistance" under the FTC Rule.[85] The FTC's guidance, however, expressly exempts "trademark controls designed solely to protect the trademark owner's legal ownership rights in the mark under state or federal trademark laws" from its identified indicia of control, meaning that controls imposed simply to preserve the integrity of the brand license will not establish an accidental franchise.[86]

Consistent with FTC guidance, few reported decisions find franchise relationships arising from trademark licenses alone. To be sure, various courts have held that so-called "license agreements" actually established franchises, but the contracts at issue in these cases generally provide for substantial licensor control over licensee business operations, not mere control over the licensee's use of the licensor's mark.[87]

In any event, due to the fact-intensive nature of the naked licensing and accidental franchising analysis and the few bright lines provided by applicable law, a franchisor seeking to undertake licensing must scrutinize its anticipated license program to avoid creation of another franchise.[88] This scrutiny is particularly important when dealing with state franchise laws or

from asserting rights to the trademark.'"); FreecycleSunnyvale v. Freecycle Network, 626 F.3d 509, 515–16 (9th Cir. 2010) ("We have previously declared [in *Barcamerica*] that naked licensing is '*inherently* deceptive and constitutes abandonment of any rights to the trademark by the licensor.'").

84. Fed. Trade Comm'n, Franchise Rule Compliance Guide 3 (May 2008), https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf.

85. *Id.*

86. *Id.* at 4.

87. *See*, *e.g.*, Syncsort Inc. v. United States, 31 Fed. Cl. 545, 549 (1994) (holding license agreements constituted franchise agreements for purposes of tax treatment of payments received by licensor under licenses); Safe Step Walk in Tub Co. v. CKH Indus., Inc., 242 F. Supp. 3d 245, 258 (S.D.N.Y. 2017). Neither *Syncsort* nor *Safe Step* dealt with "simple" licenses: In *Syncsort*, the license agreement gave the licensor the right to prescribe quality standards for the licensee's operations and restricted the licensee's marketing of competitive products, among other things. 31 Fed. Cl. at 549. And in *Safe Step*, the license agreement allowed the licensor "to set minimum sales requirements," to assist with the licensee's marketing plan, to direct changes to the licensee's business model, and to terminate the license agreement for the licensee's failure to provide certain financial reports. 242 F. Supp. 3d at 258.

88. *See* cited cases *supra* note 83.

other franchise-adjacent issues not controlled by the FTC Rule and associated guidance.[89]

B. *Encroachment and Unfair Competition*

Franchisees often look askance at franchisor attempts to increase the franchisor's revenue that they perceive to come at the expense of the franchisee. Of course, a benefit to the franchisor does not necessarily entail a detriment to a franchisee, and franchisor use of e-commerce and alternative distribution channels can raise the franchise's brand profile to the advantage of all involved parties. But, rightly or wrongly, franchisees may claim to lose out where a franchisor seeks to market its own goods or services directly to buyers through alternative distribution channels.[90] These claims often are grounded in allegations of franchisor encroachment or unfair competition.

Encroachment in the traditional sense occurs when a franchisor allows another franchise unit to operate near an existing franchisee's physical premises.[91] But with the recent explosion of e-commerce, a franchisee might claim encroachment based on any number of things. For instance, a franchisor might accept and fulfill an online order by a customer located in a franchisee's exclusive territory. Similarly, a digital delivery platform might route a customer's order through a neighboring franchisee, effectively allowing the neighboring franchisee to sell to customers in the first franchisee's exclusive territory.

Due to the proliferation of arbitration provisions in franchise agreements, many disputes arising from electronic encroachment have been resolved confidentially and outside of the public judicial process.[92] But, as illustrated by a handful of decisions from federal courts, the typical analysis of an electronic encroachment claim starts (and often ends) with the language of the franchise agreement—much like in cases of physical encroachment.

In *Stillwell v. RadioShack Corp.*, the franchisees alleged that RadioShack had breached its franchise agreements by making direct internet sales to

89. For instance, the Internal Revenue Code provides that certain asset transfers from franchisees to franchisors do not qualify for preferential treatment as capital gains. 26 U.S.C. § 1253(a). Such transfers do not qualify as capital gains if the franchisor "retains any significant power, right, or continuing interest" in the franchise. *Id.* This includes the "right to prescribe the standards of quality of products used or sold, or of services furnished." *Id.* § 1253(b)(2)(C). Under this definition, trademark quality controls necessary to avoid naked licensing could establish "significant power" and require tax treatment of licensee payments as franchise fees rather than license fees or royalties.

90. Charles S. Marion, Daniel J. Oates & Ari N. Stern, *Stepping on Toes: Territorial Rights & Encroachment*, Am. Bar Ass'n, 42nd Ann. Forum on Franchising W-14, at 37 (Oct. 7–9, 2019) ("[F]ranchisors' efforts and strategies to expand their on-line presence and business can be viewed suspiciously by franchisees as an attempt by the franchisor to infringe upon their business and customers and cannibalize their revenue.").

91. *See, e.g.*, Barnes v. Burger King Corp., 932 F. Supp. 1420, 1425–41 (S.D. Fla. 1996) (analyzing various legal theories advanced by franchisee in response to franchisor opening another franchised location "approximately five blocks" from the franchisee's location).

92. Emily I. Bridges, *Keep Off My (Virtual) Lawn: Encroachment in the Age of the Internet*, 36 Franchise L.J. 415, 418 (2017).

customers residing in franchisee territories.[93] The franchise agreements granted the franchisees an Area of Primary Responsibility and provided that, within that territory, RadioShack would not (1) open a company store; (2) authorize the operation of a franchised store "without first giving Franchisee an option to open such unit"; or (3) authorize the establishment of an "Authorized Sales Center."[94] The franchisees claimed that, by marketing to customers in the franchisees' territories and otherwise competing with franchisees in their territories, RadioShack had breached the Area of Primary Responsibility provision.[95] RadioShack moved for summary judgment, and the district court granted the motion.[96] The court reasoned that the provision did not prohibit RadioShack from directing customers in franchisee territories to RadioShack's website or company-owned stores or otherwise competing with franchisees beyond the three ways enumerated in the franchise agreement.[97] Although the franchise agreements predated the modern Internet, at the time the agreements were executed RadioShack was engaged in "direct catalog sales via mail order and telephone," which the franchise agreement did not prohibit "in any fashion."[98] As a result, the court concluded that the franchise agreement "[did] not prohibit internet sales by RadioShack."[99]

Similarly, in *Newpaper, LLC v. Party City Corp.*, a Party City franchisee called Newpaper claimed breach of contract based on Party City's online sales to customers in the franchisee's territory.[100] The franchise agreement granted Newpaper the exclusive right to operate franchised stores in its territory.[101] But the agreement expressly placed no restriction on Party City's

> offering or selling products, including the same or materially the same products . . . as those offered and sold by the Newpaper franchised Party City retail goods stores to customers located within the Territory through any channel of distribution, including wholesale sales and sales by or through the internet, and from any premises other than a Party City-owned retail store premises located within the Territory.[102]

The parties also entered an "Internet Addendum" after Party City began selling its products online, under which they agreed that Party City was "not prohibited from selling any products over the Internet, to any customers regardless of location, and in any manner whatsoever."[103] Despite these provisions, Newpaper claimed that Party City's Internet sales breached the

93. Stillwell v. RadioShack Corp., 676 F. Supp. 2d 962, 968 (S.D. Cal. 2009).
94. *Id.* at 967–68.
95. *Id.* at 970.
96. *Id.* at 970–71.
97. *Id.* at 970.
98. *Id.*
99. *Id.*
100. Newpaper, LLC v. Party City Corp., 2013 WL 5406722, at *4 (D. Minn. Sept. 25, 2013).
101. *Id.* at *1. Although not at issue here, the agreement also allowed for three preexisting non-franchisee stores to continue operation in the franchisee's exclusive territory. *Id.*
102. *Id.* at *4.
103. *Id.*

franchise agreement's exclusivity clause.[104] The district court dismissed the breach claim with prejudice, concluding that "the [Franchise] Agreement expressly allows for [online] sales."[105] The court reasoned that the parties "unambiguously and unqualifiedly" agreed that Party City had the right to sell its goods "by or through the internet" and that Newpaper cited no contractual provision "that contradict[ed] or preclude[d] this right."[106]

Stillwell and *Newpaper* teach that, as with other encroachment claims, a franchisor's best defense to a claim of Internet encroachment is a well-drafted franchise agreement.[107] Despite prevailing on the encroachment claim even though its franchise agreements did not expressly reserve the right to sell products online, RadioShack had to shoulder the expense and burden of discovery before it could prevail on summary judgment. In contrast, Party City executed multiple agreements with its franchisee expressly allowing Party City to sell its products online and through alternative distribution channels. This language allowed Party City to obtain the dismissal of the breach claim, thereby minimizing the litigation expenses that it incurred in defending the encroachment claim. As illustrated by these decisions, franchisors should use specific contract language reserving their rights to operate alternative distribution channels, including but not limited to online sales and similar methods of distribution.[108]

Of course, contract language can only go so far in insulating franchisors from claims by franchisees. This is particularly the case where a franchisor acts in a way that directly competes with or otherwise unfairly undermines its franchisees.[109] In *Carvel Corp. v. Baker*, for instance, a franchisor of ice cream stores brought a declaratory judgment action against certain franchisees, seeking a declaration that the franchisor's sales of ice cream directly to supermarkets did not violate the franchise agreements.[110] Historically, the franchisor only allowed its products to be sold at franchised and company-owned stores, not supermarkets.[111] Indeed, the franchisor had "assured franchisees that [it] had no plans to enter the supermarket business due to the devastating effect such a policy would have on its franchisees."[112] But just two years after making these assurances, the franchisor began selling its products in supermarkets.[113] The franchisor moved for summary judgment, but the

104. *Id.* at *2.
105. *Id.* at *5.
106. *Id.*
107. *See* Marion, *supra* note 90, at 38 ("As with the other types of encroachment claims, the best way of minimizing the risk that there will be disputes arising from the franchisor's beginning to distribute and sell its products or services through alternative distribution channels is to include specific language in the franchise agreement detailing what the parties' rights are in such situations.").
108. *See* Bridges, *supra* note 92, at 426.
109. *See, e.g.*, Carvel Corp. v. Baker, 79 F. Supp. 2d 53, 66 (D. Conn. 1997).
110. *Id.* at 55.
111. *Id.* at 56.
112. *Id.*
113. *Id.*

district court denied the motion in large part.[114] The court reasoned that the benefit to franchisees in entering the franchise agreements included "participation in a 'unique system for the production, distribution, and manufacturing of [the franchisor's] products.'"[115] Because sales to supermarkets deprived franchisees of this benefit, the district court found an issue of material fact as to whether the franchisor had violated the implied covenant of good faith and fair dealing and therefore held summary judgment inappropriate.[116] The court reached this conclusion even though certain of the franchise agreements expressly stated that the franchisor had "sole and absolute discretion" to sell its products through "other distribution channels or concepts."[117] As the court explained, the franchisor made direct sales to supermarkets that were direct competitors of the franchise, and franchisees "could have reasonably expected" that the franchisor would not use alternative distribution channels "to compete directly against them, especially since distribution to supermarkets and other retail outlets was not a practice that existed prior to [execution of] the agreement."[118]

Carvel reveals the limits on the power of contract language: some of the franchise agreements expressly allowed the franchisor to sell products through "other distribution channels or concepts" in the franchisor's "sole and absolute discretion," which should have covered sales through supermarkets.[119] But because such sales directly undermined the franchisees' businesses—and because the franchisor had assured franchisees that supermarket sales were off the table just two years before implementing its supermarket program—the district court still denied the franchisor's motion for summary judgment.[120] Perhaps the franchisor could have pursued its supermarket program if its franchise agreements contained a stronger, more specific reservation of franchisor rights. As it stands, *Carvel* shows that even franchisors with well-drafted franchise agreements should scrutinize plans to implement alternative distribution channels. If an alternative distribution channel would undermine franchisees, promote intra-brand competition, or otherwise unfairly compete with franchisees, selling goods or services through that channel creates potential exposure for the franchisor.

IV. Conclusion

This article encourages franchise attorneys, franchisors, and franchisees, as well as licensing parties, to think about the variety of ways that franchise brands can generate revenue outside the traditional franchise relationship operation. Franchisors should not only strive to be creative and seek

114. *Id.* at 66.
115. *Id.* at 62.
116. *Id.* at 61–62.
117. *Id.* at 66.
118. *Id.*
119. *Id.*
120. *Id.*

alternatives for generating increased revenue and brand value, but also consider the ways such alternatives can increase brand recognition to drive more marketplace activity and business to their franchisees. Of course, venturing away from the day-to-day franchise agreement should be done only with careful consideration of the risks and the opportunities. The same diligence and attention paid to finding the right franchisee should also be invested in finding the right alternatives for the franchise brand and the desire to expand in an effort to generate alternative revenue streams.