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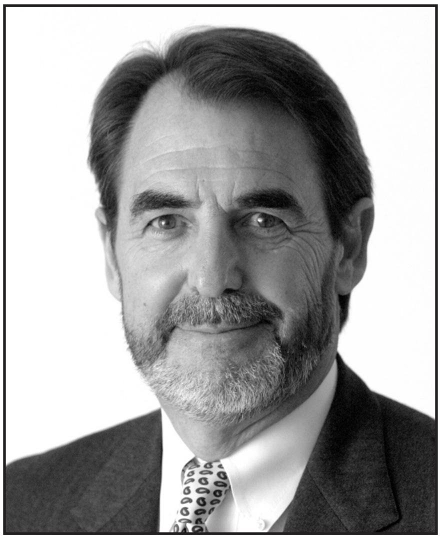
The Licensing Corner



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DISTRIBUTION AGREEMENTS: IS IT SOFTWARE, HAMBURGERS OR SUBSCRIPTIONS?

Licensing Interest Group webinars earlier this year introduced many interesting subjects, with two topics raising questions about agreements that govern distribution. This column continues those discussions.

Here are two scenarios:

1) **SaaS:** *Your client provides its software via the Cloud—a SaaS model—with resellers and systems integrators distributing directly or integrating your software as a module in a larger enterprise "solution."*
2) **The Hamburger/Software Franchise:**[1] *Your client grants its distributor the right to distribute software. The agreement includes a license to use the client trademark, subject to approval of such use. Your client offers a marketing program and also has the right to review the distributor's marketing efforts. The distributor also pays for mandatory staff training. It also pays your client a monthly royalty.*

PART 1: THE SAAS MODEL: RESALE? LICENSE? MAGAZINE SUBSCRIPTION? RESALE OF SUBSCRIPTIONS?

Distributors or resellers (*e.g.,* VARs) have been working with software companies since the veritable dawn of time. However, with new distribution methods such as the Cloud, the reseller agreement template for such relationships might not work. What's not clear is what actually works. What *is* clear is that the drafting lawyer will need to understand the technical flow of rights, access and use.

Here's why. In simple terms, software is *delivered* these days by download or it is *used* by access through the Cloud. With downloads, a user gets a copy of the software. However, the distributor has neither purchased a copy of the software from the software company, nor has it resold it to the downloading user. What is the transaction? Absent other facts, it probably should be a license (to the reseller), with a right of sublicense (to the user).

SaaS Changes Things. SaaS is different: There is no copy provided to the user and, typically, not even to the distributor. The user gets web *access* to the software. No copy, therefore no license. At least so say some practitioners. And, not surprisingly, other practitioners differ, arguing that access and use are rights and they have to be granted *some* way, so a license works just fine, thank you very much. Maybe, maybe not.

What does a user get? Well, the closest analogy might be a *subscription.* Users receive a subscription that gives them the right to access the software—much like a subscription to a magazine or a newspaper. Typically, it is an access or registration code. But that might not be sufficient, either, because the point is they get a right to *use* the software, not simply read content.

Are Resellers Reselling (Again)?

What, then, do the distributors (AKA resellers) get? This gets a bit tricky. Perhaps they get a stack of subscriptions, at least metaphorically speaking. If that is the case, then perhaps the distributors actually *are* taking title—in the stack of subscriptions. They in turn *resell* those subscriptions to the users. If that is the case, then we have come full circle and the old reseller agreement template might once again apply.

Or, perhaps these distributors are, essentially, lead—or perhaps *traffic*—generators. The resellers give the code to the users and the users go to the software company website to access the software, where they register with the software company.

Licenses May Never Disappear. Finally, whether or not there is a resale, a license or a subscription at the center of the relationship with the user, a distribution agreement will have to take into account *some* licenses. If the software company is working with a system integrator (or solutions provider), then, typically, the integrator will need a license to copy the software for integration into its solution. Moreover, every user will need a license granting a right to the data and results arising from the use of the software in a SaaS model.

So hone your flowchart skills before you (re)draft that reseller, VAR, license, or integration agreement.

PART 2: IS SOFTWARE DISTRIBUTION LIKE SELLING HAMBURGERS?

Let's try a quick test on a distribution agreement that governs the relationship of your software client with a distributor. Under this agreement:

> The distributor has the right to distribute goods, a license to use the client trademark and access to a client-provided marketing program. Your client can review marketing efforts. The distributor pays a monthly sales-based royalty and periodic fees for mandatory staff training.

Is this relationship the same as that between, say, McDonald's and one of its hamburger stands? (OK, so they're not stands any longer. Sue me.) The answer is, well, it probably is a franchise.

Hamburgers and Your Client: The Accidental Franchise

In your view, your client does not sell hamburgers or anything else you expect would be sold as a franchise. Therefore, your client could not possibly *be* a franchise.

Think again. It does not matter what the business is—whether it is selling hamburgers, hawking insurance policies, distributing forklifts, pushing Girl Scout cookies or generating orders for financial and accounting software: Similar to the old saying about ducks, if the relationship has the "magic elements" of a franchise, then it is a franchise, and subject to potentially onerous regulations and civil and criminal remedies and penalties.

The Magic Elements: Trademark, Assistance and Payment

Federal and state laws vary the language of the definition of a franchise but, basically, it comes down to three elements: use of a trademark: significant control or assistance; and some form of payment from the franchisee (or distributor in our case) to the franchisor (your client).[2]

At the federal level, the Federal Trade Commission published its Franchise Rule Compliance Guide (the "FTC Guide") with a useful summary of the definition:

> [… A] commercial business arrangement is a "franchise" if it satisfies three definitional elements. Specifically, the franchisor must:
>
> (1) promise to provide a trademark or other commercial symbol;
>
> (2) promise to exercise significant control or provide significant assistance in the operation of the business; and
>
> (3) require a minimum payment of at least $500 during the first six months of operations.[3]

The Devil, and perhaps redemption, is in the details of the language. Your first reaction might be to draft the agreement with special attention to such words as "significant control." That gets complicated. The FTC Guide points out that "formal sales, repair, or business training programs"[4] would be significant control, while certain trademark controls would not be.[5]

It's even more complicated by distribution relationships that can be subject to laws in some twenty states (including California) that diverge from the FTC guidelines. While each of these laws generally follows the three-element definition, each of the courts of those states has defined these elements in ways that frustrate any kind of bright-line guidance.

One thing can be said about them all: The courts take an expansive view of the application of the franchise laws. In one state, mandatory training constituted control; in another state, merely the *availability* of a trademark for use was sufficient to meet the first element; and in a third state, a distributor's nominal payments (under $2,000) to a fork-lift manufacturer over a twenty-year period was sufficient to meet the "payment" element. Distributing software might not differ enough from selling hamburgers to make any difference.

Our Hypothetical

While there is very little case law applying these franchise laws to software, we know enough to suggest that our hypothetical could be hit by the accidental franchise landmine.[6] The license to use the trademark—and a review of its use—might pass muster at the federal level but not at the state level. Providing a marketing program and having the right to review the marketing efforts of the distributor could meet the second element (significant control). Finally, payment for mandatory training and the royalty would meet the "payment" element.[7]

So What?

Lawyers with distribution arrangements typical in the software industry have three options, each of them a difficult choice.

Avoid One of the Three Elements

The first is to build the relationship without at least one of the three elements, with the distribution agreement making this quite clear. This is the approach I prefer, but it is not necessarily pretty. So, going through each of the elements:

Do not grant a license to your client's trademark, for example, and there is no "trademark" element. But just how viable is that option? Raise your hand if your client wants to lose the marketing and branding benefits.

There are similar issues with the second and third elements, "control/assistance" and "payment," although each of them might be easier on the relationship. Make it clear that the distributor is free of any influence in the manner under which the distribution responsibilities are fulfilled. Likewise, limit payment only to wholesale purchase of your goods or services. This becomes very problematic if your relationship is a SaaS or license model, because there is no wholesale "purchase." Unfortunately, there is little positive guidance in these new means of distribution.

Treat it Like a Franchise

Given the thicket of state law cases with contradictory fact patterns, it is possible to just bite the proverbial bullet and use the franchise model, which requires comprehensive disclosure and registration. This approach, favored by some commentators, strikes me as too expensive and complicated.

Seek an Exemption

There are many exemptions to the franchise laws at both the federal and state levels. Some of them are tempting, *e.g.,* the "single license trademark exclusion" at the federal level. There are two problems with this approach. Some of the federal exemptions do not apply at the state level and, in any case, the requirements to meet some of the exemptions are intricate and strict. However, there is much to be said for further analysis of this approach.

CONCLUSION

So dust off those templates on your hard-drive and check to see if you have the right mix of license and subscription when it comes to the SaaS world and if you have enough there to counteract the magic elements of accidental franchises.

The views expressed in this article are personal to the author and do not necessarily reflect the views of the author's firm, the State Bar of California, or any colleagues, organization, or client.

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Endnotes

1. I am grateful to Gerard Davey, Esq., a certified specialist in Franchise and Distribution Law, who was my co-presenter in one of the webinars, *License Agreement Landmines: Accidental Franchises in the Digital World*, April 24, 2014. Any errors in this column are mine, not his.
2. Commentators vary in their "names" for the three elements at the state level, *e.g.,* in California, the "trademark" element, "marketing plan" element and the "fee" element. Some states replace "marketing plan" with "community of interest." For simplicity, I will use the FTC terms.
3. United States Federal Trade Commission, *Franchise Rule Compliance Guide*, May 2008, PDF downloaded from http://www.business.ftc.gov/documents/bus70-franchise-rule-compliance-guide. [Formatting altered for this column.] ("FTC Guidelines")
4. *Ibid*., at 3.
5. *Ibid*., at 4. It is worth quoting the language in its entirety:

   In addition, the following items do not constitute significant control or assistance, as a matter of Commission policy:

   - *trademark controls designed solely to protect the trademark owner's legal ownership rights in the mark under state or federal trademark laws (such as display of the mark or right of inspection); […]*
6. As to software, *see Gentis v. Safeguard Business Systems* (1998) 60 C.A.4th 1294.
7. FTC Guidelines, at 5. *See also, Boat & Motor Mart v. Sea Ray Boats* 825 F.2d 1285 (9th Cir. 1987) (payments for manufacturer's promotional materials could be franchise fees).