FUNDAMENTALS
OF
FRANCHISING YOUR BUSINESS

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OUTLINE OF TOPICS

I. What is a Franchise?

A. Common Sense Definitions

1. Definition by Example

McDonald's, Wendy's, Dairy Queen, Holiday Inn, Molly Maids, Midas Mufflers, and the other 6,000+ franchise systems operating in the United States.

2. Practical Definition

Franchising is a method of distributing goods or services. A franchise is a type of business in which someone (the franchisee) agrees to pay certain fees and obey certain rules for the right to sell the goods or services of an established company (the franchisor) and benefit from its business methods, trade secrets, goodwill, professional training, and operating assistance.

3. Elements of a Franchise

Under federal law and most state franchise statutes, a franchise consists of the following three elements:

(i) Trademark Element. The franchisee operates his business under the franchisor's trademark or service mark or distributes goods or services associated with the franchisor's marks.

(ii) Fee Element. The franchisee is required to make a payment to the franchisor (or an affiliate of the franchisor) as a condition of obtaining or beginning the franchise operation.

(iii) Control/Assistance Element. The franchisee is subject to various requirements imposed by the franchisor, including requirements regarding the location of the franchised business, site design or appearance, hours of operation, sales methods, management systems, marketing, etc.

B. Legal Definitions

1. Federal Law: The FTC Rule

The federal franchise regulation is formally titled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" and can be found at 16 Code of Federal

Regulations Part 436 (the “FTC Rule”). The FTC Rule defines a “franchise” as follows:

> 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 identified or associated with the franchisor’s trademark, or to offer, sell, or distribute goods, services, or commodities 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.

2. <u>State Law: The Virginia Retail Franchising Act</u>

The Virginia Retail Franchising Act is codified at Sections 13.1-557 through 574 of the Code of Virginia of 1950, as amended (the “Virginia Franchise Statute”). The Virginia Franchise Statute defines a “franchise” as follows:

> a written agreement under which (i) a franchisee is granted the right to sell goods or services at retail (not wholesale) under a marketing plan or system prescribed in substantial part by the franchisor; (ii) franchisee’s business is operated under franchisor’s trademark, trade name, or other commercial symbol designating the franchisor or one of its affiliates; and (iii) the franchisee is required to pay, directly or indirectly, a franchise fee of $500 or more.

C. Common Franchise Types

1. Business Format Franchise

A business format franchise involves a franchisor offering a franchisee the right to use its business methods and systems in addition to selling the franchisor's signature goods and services. The business format franchisees use the same procedures, recipes, and practices of the franchisor. Examples include typical restaurant franchises, home cleaning service franchises, and auto repair franchises.

2. Product Franchise

A product franchise is a type of franchise in which a manufacturer of a product contracts with a select number of retailers or wholesalers to distribute its products. The retailer or wholesaler typically gets the right to identify itself as an "authorized dealer" of the franchisor.

D. Similar Types of Business Relationships

1. Business Opportunities

Although precise definitions vary from state to state, a "business opportunity" is commonly defined as the sale of products, equipment, supplies, or services to a purchaser upon payment of an initial fee for the purpose of enabling such purchaser to start conducting business, and in which the seller represents that he will provide a sales program that will enable the purchaser to derive income from the program exceeding the price paid to the seller. Common examples include vending machine routes, envelope-stuffing programs, automobile cleaning systems, and coin-operated telephones, among others.

The FTC Rule regulates franchises and business opportunities, but most states govern franchises and business opportunities under separate statutes.

Business opportunity statutes typically require pertinent information to be disclosed at designated times prior to the sale of a business opportunity. Some business opportunity laws require a seller to obtain a surety bond or establish a trust account prior to making sales. Other statutes also impose registration requirements.

2. Distributorships

A distributorship is a contractual relationship in which a manufacturer or supplier authorizes a distributor to distribute or sell supplies or products to others. The distributor buys the products from the manufacturer or an authorized supplier and often is entitled to identify its business by the supplier's trademark. Distributorships typically will not be classified as franchises under federal or state law unless the manufacturer or supplier provides significant operating assistance or imposes significant control over the distributor in exchange for payment of a fee. Unfortunately, it is all too common for parties to inadvertently structure a distributorship arrangement in such a manner that it constitutes a franchise under applicable law.

3. Licensing Relationships

Owners of trademarks or other intellectual property that have developed a level of public recognition and secondary meaning will often find it advantageous to license such intellectual property to someone else in connection with another line of business. For example, professional sports leagues regularly license the use of team logos on all types of merchandise.

Structured properly, a single-mark licensing arrangement is a valid alternative to franchising and offers the owner an excellent opportunity to maximize the value of its intellectual property by increasing brand recognition through identification with new products and services at a lower cost to the owner.

A primary risk under a typical licensing arrangement is that the licensor exercises little or no control over the licensee beyond periodic oversight to monitor quality control over the licensee's use of the intellectual property. In other words, a licensor will have significantly less control in a licensing relationship than it would as a franchisor in a franchise relationship.

4. Inadvertent Franchises and the Confusing Interplay of Federal and State Law

When structuring a licensing relationship, distributorship, or similar type of arrangement, the parties must carefully examine the substance of the underlying relationship to avoid inadvertently creating a franchise relationship. It is also possible for a certain business relationship to be defined as a franchise under the FTC Rule, but not fall within a particular state's definition of a franchise (and vice versa). When a company desires to do business in several states, each state's franchise and business opportunity laws must be examined. What is considered a franchise in Virginia may not be a franchise under Georgia law. A business opportunity under Florida law could be a franchise under North Carolina law and neither a franchise, nor a business opportunity under Mississippi law.

II. Why Franchise?

A. A Brief History of Franchising

The word “franchise” comes from a medieval French term “francis” which meant to grant rights or privileges to peasants. In the Middle Ages, a local lord would give others the right to hunt, hold markets and fairs, or engage in other activities on his land. These were the earliest franchise relationships and gradually evolved through the Common Law.

Modern franchising as we know it today was developed by German beer brewmeisters and the Singer Sewing Machine Company in the mid-1800s. Isaac Singer negotiated licensing fees from independent salesmen for the right to sell Singer Sewing Machines in a defined territory. By the Great Depression, franchising was gaining momentum with the beginnings of the A & W Root Beer and Dairy Queen franchise systems.

The golden age of franchising really started to take off in the years following World War II and has continued through today. There are several socioeconomic factors that help explain this growth, but that is beyond the scope of this outline. Society’s increased mobility and desire for predictability and uniformity have fueled the explosive growth of franchising in this country.

B. Benefits of Franchising

Franchising has become increasingly popular over the past 30 years. According to the International Franchise Association (“IFA”), franchising’s annual retail sales exceed $1 trillion. Not only are established franchises expanding, but new industries are starting to franchise. With the evolution of co-branding, franchised businesses are reaching new markets and utilizing new distribution channels (e.g., convenience stores, sports arenas, college campuses, shopping malls, office buildings, amusement parks, etc.).

Business owners realize that franchising can offer the following fundamental benefits:

1. rapid market expansion at reduced costs;

2. increased revenues from franchise fees and royalties; and

3. bulk discounts from suppliers and advertisers.

C. Humble Beginnings of Some Successful Franchises

1. Baskin-Robbins. Irv Robbins opened his first ice cream store in Glendale, California. He named his store "Snowbird" and proudly featured 21 flavors of ice cream. In 1946, he teamed up with his brother-in-law and competitor, Burt Baskin, to form Baskin-Robbins. After opening six successful locations, the two businessmen began licensing their business format to others, thus giving birth to the world's first ice cream franchise.

2. Pizza Hut. While Frank and Don Carney were in college, a friend convinced them in 1958 to open a pizza parlor in Wichita, Kansas. They borrowed $600 from their mother to buy some used equipment, rented a small building, and opened the first Pizza Hut. The first franchised Pizza Hut opened the following year. By 1968, there were over 300 Pizza Hut locations serving over 1 million customers each week. The growth and popularity of the franchise continued throughout the rest of the century.

3. Holiday Inn. Kemmons Wilson opened the first Holiday Inn in Memphis, Tennessee in 1952. Special features introduced for the first time included a "children stay free" feature, swimming pool, air conditioning, telephones, free parking, and a restaurant. Wilson soon started selling franchises at a time which coincided with the massive expansion of the U.S. interstate highway system. By 1968, there were over 1,000 Holiday Inns across the United States.

4. Midas Mufflers. Nate Sherman opened the first store in Macon, Georgia in 1956, introducing the lifetime muffler warranty. Within a year, there were 100 locations. The first international location opened in Canada in 1961. The franchise steadily grew and by the 1980s, there were over 2,000 Midas Muffler locations.

5. Subway. Frank DeLuca was 17 years old when a family friend, Dr. Peter Buck, convinced him to open a submarine sandwich shop. They joined forces to open "Peter's Super Submarines" in 1965 in Bridgeport, Connecticut. They quickly opened several other locations as they plotted an aggressive growth strategy. They changed the name to "Subway" and began selling franchises in 1974. By 1999, there were over 14,000 Subway locations.

III. Is Franchising Right for Your Business?

A. Key Indicators of a Successful Franchise System

As you contemplate franchising your business, you should first consider the following common indicators of a successful franchise system:

1. one or more successful, company-owned stores;

2. a business plan or set of procedures, processes, or recipes that can be easily learned and replicated from location to location;

3. an effective training and assistance program;

4. marketable goods and services that have wide appeal;

5. a reasonable growth plan;

6. well-protected intellectual property (trademarks, logos, copyrights, trade secrets, etc.);

7. a management team with franchising experience;

8. an effective franchise marketing and sales program;

9. a strong understanding and appreciation of the franchisee perspective; and

10. sufficient financial strength to fulfill obligations to franchisees.

B. What Kinds of Businesses are Franchisable?

While virtually any business in any industry can be franchised, some industries are more susceptible to successful franchising than others, including the following:

1. restaurant/food service concepts, provided the recipes, menus, and operating procedures are easy to replicate;

2. businesses that manufacture or supply goods and services with widespread consumer appeal;

3. businesses that currently operate in fragmented industries not already saturated with franchised brands; and

4. businesses with procedures and systems that are easily learned and implemented.

According to data published by the IFA, emerging franchise systems showing rapid growth in recent years include the following categories:

1. personal fitness;
2. real estate brokers/services;
3. coffee and tea;
4. deli/sub sandwich shops; and
5. specialty/gourmet retail foods.

C. Misconceptions About Franchising

Common misconceptions about franchising include:

MYTH: With a successful, marketable concept or product, financial success is guaranteed.

REALITY: Franchising is, in many respects, a separate business requiring a significant investment of resources, commitment, and patience to succeed in an increasingly competitive market.

MYTH: Franchise locations can operate independently without supervision from the franchisor once they survive the start-up period.

REALITY: The franchisor must actively supervise, monitor, and assist its franchisees to promote the growth and success of the franchise system over the long term.

MYTH: A franchisor is free to open company-owned stores wherever it wants.

REALITY: This depends on the specific wording of the relevant franchise agreement. There may be potential liability for encroachment or unfair competition with nearby franchisees.

IV. Common Elements of a Successful Franchise System

A. Replicable Products or Services

Franchising is not appropriate for every business. Prior to franchising, a business owner should examine its products and services to determine if franchising is a viable growth and distribution strategy. Successful franchise systems utilize a plan or set of procedures that are easily learned, copied, and maintained from one location to another. Consistency is an essential ingredient of a franchise system.

B. Protectable Trademark and Other Intellectual Property

A significant portion of the value a franchisor has to offer its franchisees is the goodwill associated with its brand. Prior to franchising, a business owner should protect its trademarks and other intellectual property through federal registration. After registration, the franchisor should take the proper steps to maintain its trademarks and intellectual property and protect against brand deterioration.

C. Effective Franchise Structure

There are several different types of franchising structures. A business owner should examine its line of business and financial situation to determine which franchise structure best fits its model. A brief explanation of various options is provided in the "Different Franchise Structures" section below.

D. Recruiting Franchisees at a Manageable Rate in Identified Markets

A successful franchisor understands the limitations on its ability to effectively expand its franchise network. Prior to expanding, a franchisor should examine its infrastructure to determine if it will support additional franchisees. Prior to entering into a new market, a franchisor should determine which markets are: (a) not saturated by competition, (b) located where the franchisor can effectively monitor and service its franchisees, (c) located where the franchise's trademark is recognized and respected, and (d) located where the franchisor can economically deliver products and materials to its franchisees.

E. Franchisee Support – Operating and Management Services

A successful franchisor creates and maintains uniform operating and management systems for use by its franchisees. Uniformity ensures a consistent level of product and service quality throughout a franchise system. A successful franchisor also provides valuable services to its franchisees, including, but not limited to: (a) advertisement and marketing programs, (b) research and development of new products and services, and (c) procurement of materials, equipment, and goods for operation of the franchise location.

V. Different Franchise Structures

A. Single-Unit Franchises

A single-unit franchise agreement grants a franchisee the right to construct and operate a single franchised business in a specific location. Under such an agreement, a franchisor may grant a franchisee territorial protection, or reserve the right to franchise other units or open company-owned units. Although this structure slows market penetration, it allows for calculated growth and remains the most common franchise structure in the United States

B. Area Development Programs

An area development agreement grants a franchisee the right to open and operate an agreed-upon number of franchise locations within a defined territory. Area development agreements generally require a franchisee to commence operating the franchised businesses within a specified timeframe and to execute a separate franchise agreement for each location. Area development agreements allow franchisors to attract more sophisticated, wealthier franchisees wishing to open a cluster of franchises, increasing franchisor's income stream through more rapid development.

C. Master Franchise (or Subfranchise) Programs

Under a master franchise (or subfranchise) agreement, a franchisor divides its market into large territories and allocates the territories to various master franchisees. Each master franchisee is then empowered to recruit and sell unit subfranchisees to individual operators who will operate the subfranchised units. The franchisor generally retains national rights such as advertising and product development, while delegating local and regional rights to the master franchisees. Other than granting subfranchises, the master franchisees generally collect fees and provide certain consulting, promotional, and training services to unit subfranchisees. They often also own and operate one or more franchised units. Although under a master franchise agreement, the franchisor must relinquish some control and part of its revenue to its master franchisees, such agreements allow for rapid growth and decrease franchisor's costs to solicit and service franchisees.

D. Area Representative Programs

Under an area representative agreement, an area representative acts as an agent of the franchisor to market and solicit prospective unit franchisees within a defined territory. Once potential unit franchisees have been identified, the franchisor enters into franchise agreements directly with the identified franchisees. The franchisor is typically responsible for providing services and collecting fees (some portion of which will often be shared with the area representative). This arrangement allows the franchisor to retain greater control over franchisee selection and operations, but exposes the franchisor to potential vicarious liability for an area representative's failure to comply with disclosure obligations or misrepresentations.

E. Conversion Franchise

Under a conversion franchise arrangement, a franchisee converts its preexisting business into a franchise by replacing its current mark and system with those of the franchisor. This is a common approach of franchisors in the real estate brokerage and hospitality industries.

VI. Regulation of Franchising

There are both federal and state laws that regulate the sale of franchises. These laws first appeared in the 1970s after widespread reports of fraudulent start-your-own-business opportunities throughout the United States began getting publicized. Authorities discovered that most victims were first-time investors who had minimal business knowledge or experience.

After receiving hundreds of complaints, the FTC took a close look at this growing trend of unfair and deceptive business practices and concluded that a primary source of these problems was the informational imbalance between franchisors and prospective franchisees. As a result, the FTC concluded that prospective franchisees should be provided more complete information about franchise opportunities. These findings and conclusions gave rise to the franchise disclosure laws in effect today.

A. Federal Law: The FTC Rule

The FTC Rule is a confusing hybrid of regulation for franchises and business opportunities. The FTC Rule was promulgated in 1979 after years of investigations and hearings concerning the widespread deception and unfair trade practices of unscrupulous franchisors. Today, every franchise offered for sale in the United States is subject to the FTC Rule, which was most recently amended in 2007.

The FTC Rule requires franchisors to provide a minimum level of pre-sale disclosure to prospective franchisees.

a. Information Requirements. The FTC Rule requires franchisors to provide prospective franchisees with information about the franchisor and the franchised business being offered for sale. Each category of the required disclosure document is described later.

b. Delivery Deadline. An FDD must be given to a prospective franchisee at the earlier of: (i) at least fourteen (14) calendar days before the execution of any agreement, or (ii) at least fourteen (14) calendar days before money changes hands. Second, if a franchisor makes any unilateral changes to the form of franchise agreement (or other agreement between the parties) initially provided to the prospective franchisee, it must deliver the revised versions to the prospective franchisee at least seven (7) calendar days before execution.

c. Penalties. The FTC has the power to impose the following penalties for violations of the FTC Rule:

i. civil penalties of up to $11,000 per day for each violation of the FTC Rule or an FTC cease and desist order;

ii. FTC may compel rescission or reformation of contracts, refunds, return of property, payment of damages, and public notification of violations;

iii. FTC may issue cease and desist orders requiring a party to refrain engaging in any unfair method of competition or deceptive act or practice in or affecting commerce.[1]

d. No Private Right of Action. Private citizens cannot sue franchisors for violations of the FTC Rule. Only the FTC can take any action to enforce the FTC Rule. An aggrieved franchisee may benefit as a result of FTC enforcement action (as referenced in (c) above) or he may have available causes of action and remedies under state law, but it is important for franchisees to understand that they have no private rights to enforce the FTC Rule.

B. State Regulation

The FTC Rule does not require franchisors to file or register with any federal or state government agency. Some states, including Virginia, have franchise statutes that impose numerous restrictions, requirements, and other controls on the offer and sale of franchises. Some state franchise laws also control certain aspects of the franchise relationship, including termination and renewal rights.

1. State Registration Laws

There currently are 14 states (including Virginia) with statutes specifically requiring registration of an FDD and other materials prior to an offer or

[1] 16 C.F.R. §436.1; 15 U.S.C. §45.

sale of a franchise in that particular state. Other states impose less onerous notice filing requirements.

2. State Business Opportunity Laws

In many states without franchise statutes, and in some states that do have franchise statutes, there are business opportunity statutes. These laws generally concern the typical self-employment, "get rich quick" schemes like vending machine routes where the seller promises that a certain level of profit will be made or that all purchases are fully refundable.

3. State Franchise Relationship Laws

Some state franchise laws impose certain substantive requirements on the contractual relationship between franchisors and franchisees. Examples of such provisions under the Virginia Franchise Statute include:

a. Section 13.1-564. This provision prohibits the cancellation or termination of a franchise agreement by a franchisor without "reasonable cause." This provision also prohibits franchisors from exerting undue influence to encourage franchisees to surrender their rights under the Virginia Franchise Statute.

b. Section 13.1-565(b). This provision requires that all provisions of a franchise agreement must be negotiable to the extent that such negotiations will not hurt the uniform image or quality standards of the franchise.

VII. The FDD

A. What is an FDD?

The FDD is the disclosure document required by federal and state franchise laws to be given to prospective franchisees. This document describes the franchise being offered for sale in a standardized, plain English format. The standard format of the FDD enables individuals to efficiently compare one franchise with another.

A franchisor's FDD is not subject to prior review or approval by the federal government. A number of states have registration requirements which provide for prior state approval of a franchisor's FDD before franchise sales can take place, but such approval does not mean the state endorses or recommends a particular franchise opportunity.

As stated above, the FTC Rule requires franchisors to provide prospective franchisees with copies of the FDD at least 14 calendar days prior to any contracts being signed. This "waiting period" feature protects franchisees in two ways:

1. The waiting period provides the franchisee an opportunity to thoroughly review the documents with legal counsel and to understand all of his rights and obligations under the franchise agreement and related agreements.

2. The waiting period provides the franchisee a limited mechanism to get out of a franchise agreement if the disclosure documents were not delivered in a timely fashion under the FTC Rule and applicable state law.

Most franchisors will send potential franchisees disclosure documents upon request, although many implement a pre-screening process so that only serious candidates get access to disclosure documents.

B. <u>Breakdown of an FDD</u>

The FDD format consists of 23 categories of information about the franchisor and the franchise opportunity being offered for sale. These categories are summarized below in the order in which they appear in the FDD.

1. <u>The Franchisor and any Parents, Predecessors, and Affiliates</u>

   This section of the FDD summarizes the history of the franchisor and the franchise system being offered for sale. It will also describe the organizational structure of the franchisor, including affiliated entities (some of which might offer other franchises for sale).

   This section also will include a description of the market for the franchisor's products and services and a general discussion about the franchisor's competitors.

2. <u>Business Experience</u>

   This section will generally describe the employment histories of the franchisor's officers, directors, and other key executives with management responsibility related to the sale and operation of franchises.

3. Litigation

This section will summarize important litigation involving the franchisor, including franchisor-initiated litigation against its franchisees. This might include disputes with franchisees, customers, suppliers, or competing franchisors.

4. Bankruptcy

This section of the FDD describes any bankruptcy of the franchisor, its affiliates, officers, or directors during the last ten years.

5. Initial Fees

This section describes the initial franchise fee or fees payable to the franchisor or its affiliates related to the purchase of a franchise. The initial franchise fee will vary greatly, depending upon a number of factors, including the term of the franchise, the services offered by the franchisor, and the protected territory, if any, of the franchise granted to the franchisee.

6. Other Fees

Section 6 of the FDD will describe all fees the franchisor will collect from the franchisee for itself or third parties on an ongoing basis. These fees might include operating royalties, advertising fund royalties, lease negotiation fees, site selection fees, permitting fees, training fees, audit fees, transfer fees, and renewal fees.

7. Estimated Initial Investment

This section describes the costs a new franchisee will likely incur to start its business. This information generally comes from data gathered by other franchisees' experiences in recent years. This is valuable information for prospective franchisees who need to carefully plan budgets and business plans, obtain financing, etc.

8. Restrictions on Sources of Products and Services

This section summarizes the methods by which the franchisor attempts to preserve uniformity from franchisee to franchisee across the United States. Consistency of products and services is the essence of a successful franchise program. Therefore, a franchisor will typically have very specific requirements concerning what a franchisee can sell and where a franchisee can buy its supplies and inventory. Some franchisors require franchisees to buy certain supplies and inventory from the franchisor or affiliates of the franchisor. These sorts of relationships must be disclosed in the FDD, including the income derived by the franchisor or its affiliates from these types of requirements.

9. Franchisee's Obligations

This important section of the FDD lists the duties and obligations of the franchisee under the franchise agreement.

10. Financing

If the franchisor offers financing programs to assist its franchisees, this section of the FDD will describe the terms of such financing. If the franchisor leases equipment to franchisees, the terms of such programs will be described in this section.

11. Franchisor's Assistance, Advertising, Computer Systems, and Training

This section summarizes what services the franchisor will provide the franchisee during the term of the franchise agreement. For a prospective franchisee, this section is very important and should be studied carefully and compared with the FDDs of different franchisors. Details of the franchisor's initial training and ongoing assistance programs will appear in this section. Franchisors must offer prospective franchisees a reasonable opportunity to review any applicable operations manual or include the table of contents in the FDD.

12. Territory

This section defines the type of territorial protection (if any) the franchisor offers its franchisees. In other words, a franchisor must describe any and all limitations on its right to directly or indirectly compete with franchisees in any way. For example, many franchisors reserve the right to sell franchised goods and services through alternative channels of distribution such as convenience stores or grocery stores. Many franchisors also reserve the right to open competing locations very close to another franchisee's location. A specific disclaimer must be included if no exclusive territory is offered.

13. Trademarks

This section discloses the franchisor's ownership interest in the primary trademarks, service marks, and trade names under which the franchisor operates. These are the marks that a franchisee will be allowed to use in operating its franchised business. The franchisor's trademarks embody the franchise system's goodwill, recognizability, and uniformity. If a primary trademark is not federally registered, the FDD must include a specific disclaimer to that effect.

14. Patents, Copyrights, and Proprietary Information

This section is relatively unimportant in many cases because not many franchisors own patents that are material to the franchise system. For those franchisors who have developed patented processes or inventions, these patents will be described in this section of the FDD.

Most franchisors claim copyright protection for their operations manuals and computer software used in the operation of the franchised business. Franchisors will also strive to protect other trade secrets and proprietary information. Franchisees will be prohibited from disclosing or using such information for any purpose other than operation of the franchise system.

15. Obligation to Participate in the Actual Operation of the Franchised Business

As a general rule, franchisors believe that franchised units will be more successful if the owner of the franchise unit is directly involved in the business. Thus, many franchisors require an owner of the franchised unit to be involved in the day-to-day operation of the business (i.e., passive investors will be rejected as candidates for franchised units).

16. Restrictions on What the Franchisee May Sell

This section describes what are usually very specific restrictions on what products and services franchisees can sell. These restrictions are necessary to preserve the uniformity, consistency, and integrity of the franchise system. While these restrictions may seem strict to an individual franchisor, the fact that all franchisees in a given franchise system must comply with the same restrictions benefits each and every franchisee.

17. Renewal, Termination, Transfer, and Dispute Resolution

This section describes important provisions of the franchise agreement concerning if and how the franchise agreement can be renewed, terminated, or transferred. A franchisee does not actually "buy" a franchise but, instead, is awarded a temporary right or license to use a franchisor's business systems, products, and services for a specific period of time. These rights are not perpetual. In fact, some franchisees do not fully comprehend this concept and are surprised to learn that they have breached the agreement and their franchise is on the verge of being terminated.

While most franchise agreements give the franchisor the right to terminate the franchise agreement in several situations, franchisees typically have very limited, if any, rights to terminate the franchise agreement before its stated expiration date.

This section also describes the methods and procedures by which disputes between the franchisor and franchisee will be resolved. In many cases, all disputes must first be submitted for mediation or arbitration in the franchisor's home state. This requirement can be very burdensome to franchisees and, in effect, deter the franchisee from ever attempting to enforce its rights under a franchise agreement.

18. Public Figures

If a well-known personality (actor, pro athlete, musician, etc.) is involved with the franchise or endorses the franchise, such relationships must be described in the FDD.

19. Financial Performance Representations

This optional section of the FDD discloses historical information about the income and earnings of franchise units and company-owned units. This section also includes forecasts of future earnings. Due to the risk of liability, most franchisors do not make earnings claims. Note, however, that cost and expense information is not considered a financial performance representation under the FTC Rule; therefore, franchisors may provide that type of information to prospective franchisees.

20. Outlets and Franchisee Information

This section contains a series of statistical charts listing the number of franchised units opened, closed, transferred, terminated, non-renewed, reacquired, and projected to be opened (not including foreign units). Disclosure requirements also include providing a five-year ownership history for previously owned franchise units now under franchisor control. Confidentiality agreements with current or former franchisees must also be disclosed.

21. Financial Statements

Franchisors are required to disclose their audited financial statements for the prior two years. Under the FTC Rule, a start-up franchise system may phase in the use of audited financial statements, but some registration states may nonetheless require audited financials.

22. Contracts

This section of the FDD identifies all standard contracts the franchisor typically requires its franchisees to sign. Leases, guarantees, and promissory notes are common examples.

23. Receipts

The final page of the FDD is a receipt which is signed by the prospective franchisee to document that he received the FDD on a particular date. The franchisor will retain this receipt as proof that it complied with the disclosure requirements under the FTC Rule and applicable state law. The receipt must also be signed by any "franchise seller," a term defined as any "person that offers for sale, sells, or arranges for the sale of a franchise."

VIII. The Franchise Agreement

The franchise agreement is the actual contract between the franchisor and franchisee that governs their relationship. As referenced above, the key provisions of the typical franchise agreement will be summarized in the FDD. When drafting the documentation for your new franchise system, you should generally begin with the franchise agreement because (i) it will be the most important document from a legal and business perspective, and (ii) much of the FDD will depend on what is provided in the franchise agreement.

IX. The Operations Manual

The heart and soul of a franchise system is the operations manual. Most franchisors supply their franchisees with a detailed operations manual that provides specific step-by-step guidance on the franchise system's operating procedures, methods, guidelines, and recipes. A summary or table of contents should be disclosed in the FDD but, for obvious reasons, a franchisor should not divulge its business secrets in the FDD. These secrets, however, generally are found in the operations manual.

Operations manuals are beneficial in many ways. Besides being a key information resource for franchisees, the operations manual is useful in resolving disputes over operating procedures and standards.

An important point to remember about an operations manual is that it usually is subject to amendment at any time in the sole discretion of the franchisor. Major aspects of the franchise system can be changed by the franchisor and the franchisees will be required to obey. From the franchisor's perspective, this flexibility is necessary to allow the franchise system to grow and change to meet ever-changing consumer demand. From the franchisee's perspective, this flexibility can be burdensome to franchisees and the source of many surprises and unexpected changes in the franchise system.

For example, it will often become necessary for a franchisor to compel its franchisees to make additional capital expenditures (e.g., new signs, fixtures, or computer systems). This requirement generally will be disclosed in either the franchise agreement or the operations manual.

X. Getting Help

Developing and implementing a franchise program will possibly be one of the most significant and expensive decisions a business will make during its existence. Such a monumental decision should not be made on a whim based a need for quick capital. Sound business judgment, thorough research and analysis, and common sense should be your guide in deciding to develop a franchise program. Even with careful research and preparation, professional assistance is advisable.

A. Legal Assistance

An experienced franchise law attorney:

- can provide valuable assistance with the many legal and business issues involved with developing and implementing a franchise program;
- can assist you in comparing various franchise opportunities by reviewing the FDDs of different franchise opportunities and comparing the relative advantages and disadvantages of each franchise;
- can assist you with the planning and formation of a separate business entity or entities through which you will organize your franchise program. Using a corporation or limited liability company is almost essential to protect your personal and corporate assets from debts and liabilities arising from the various aspects of your business; and
- can also assist you with real estate acquisition or leasing issues. When starting a new business, there will be a number of employment law, tax, and estate planning needs.

B. Accounting Assistance

An accountant with experience working with franchised businesses is equally important in developing a successful franchise system. An experienced accountant can help prepare budgets and pro forma financial statements, as well as the required financial statements for the FDD. An accountant can also provide useful advice about financing the costs of developing and implementing a new franchise program and help prepare an effective business plan.

An accountant can also offer practical advice on what to expect financially as a franchisor, including anticipated rates of return, whether the proposed franchisee fee and related terms are reasonable, and other business issues. An experienced accountant can assist with federal, state, and local tax issues.

C. Franchise Consultants

Over the past 20 years, a cottage industry of franchise consulting firms has emerged to serve the unmet needs of both prospective franchisors and franchisees. For a company contemplating franchising, an experienced franchise consultant can add significant value by:

1. conducting a franchise feasibility analysis to assess potential costs and benefits of franchising for a particular company;

2. developing a strategic plan for designing and implementing a franchise program;

3. assisting with the development of operations manuals and internal policies and procedures for implementing a franchise program; and

4. providing ongoing franchise consulting and mentoring services.

D. Useful Sources of Information About Franchising

1. Internet

   i. Federal Trade Commission (www.ftc.gov)

   ii. Small Business Administration (www.sba.gov)

   iii. International Franchise Association (www.franchise.org)

   iv. American Franchisee Association (www.franchisee.org)

   v. American Association of Franchisees and Dealers (www.aafd.org)

2. Books

   i. Sherman, Andrew J., Franchising and Licensing: Two Powerful Ways to Grow Your Business in any Economy, AMACOM (2003).

   ii. Keup, Erwin J., The Franchise Bible, Oasis Press (1995).

iii. Bradach, Jeffrey L., Franchise Organizations, Harvard Business School Press (1998).

iv. Bond's Franchise Guide, published annually by Source Book Publications.

v. Meaney, James A., How to Buy a Franchise, Pilot Books (1999).

3. Periodicals

i. Franchise Times (6 issues per year)
2500 Cleveland Ave., N. Ste. D So.
Roseville, MN 55113-2728
telephone: (651) 631-4995
Internet: www.franchisetimes.com

ii. Entrepreneur Magazine (12 issues per year)
telephone: (800) 274-6229
Internet: www.entrepreneurmag.com

iii. Inc. Magazine (12 issues per year)
P.O. Box 54129
Boulder, CO 80322-4129
telephone: (800) 234-0999

iv. Franchise Law Journal (4 issues per year)
ABA Forum on Franchising
750 North Lake Shore Drive
Chicago, IL 60611
telephone: (312) 988-6101
Internet: www.abanet.org

v. Leader's Franchising Business & Law Alert (12 issues per year)
Leader Publications
345 Park Avenue South
New York, NY 10010
telephone: (800) 888-8300 (ext. 6170)

XI. Fun Facts About Franchising

A. Did You Know?

- Applebee's was the first casual-dining chain to reach the 1,000 restaurant milestone.

- The first fast food hamburger chain in the United States was White Castle, which opened its first location in 1921.

- McDonald's founder, Ray Kroc, and Walt Disney served together as ambulance drivers during World War I. Eighty years later, in 1998, McDonald's opened the first fast-food restaurant at Walt Disney World.

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XII. Glossary of Franchising Terms

Approved Supplier. A designated source from which franchise owners may purchase supplies, equipment, ingredients, inventory, and other materials for use in operating the franchise business.

Arbitration. A method of dispute resolution commonly required in franchise agreements in which disputes are resolved by an independent person or persons. Arbitration is typically—but not always—faster and less expensive than litigation. Arbitrators are often experts in franchise law or the particular industry in question. Depending upon the terms of the franchise agreement, the arbitrator's decision may be final and binding on the parties.

Area Representative. An employee or representative of the franchisor whose job it is to supervise and assist franchisees in a particular geographic area. Area representatives may, among other things, inspect franchise locations for quality and cleanliness, help franchisors solve management and technical problems, mediate disputes between the franchisor and a franchisee, and coordinate regional and local advertising and marketing efforts.

Business Format Franchising. A type of franchise whereby a franchisor sells to a franchisee a total blueprint for doing business, including, without limitation, trademark and service mark licenses, operational guidelines, site selection assistance, assistance with permits and licenses, training, and ongoing supervision and assistance. Common examples of business format franchises include fast-food restaurants, convenience stores, motels, and car rental businesses.

Business Opportunity Laws. Business opportunity laws regulate the sale of non-franchised business opportunities, common examples of which include vending machine routes, envelope stuffing schemes, and worm farming businesses. States that have such statutes typically exempt franchise systems that have federally registered trademarks or service marks or franchise systems that are already covered by franchise statutes and regulations of that state.

Buy-Back Option. A common term in franchise agreements whereby the franchisor has the right (not the obligation) to buy back all of the franchisee's equipment and inventory if the franchisee goes out of business or commits a serious breach of the franchise agreement entitling the franchisor to terminate the agreement.

Company-Owned Outlet. A franchise location owned by the franchisor. These locations typically serve as models or examples for franchisees to follow. They also serve as training facilities where new franchisees learn about the franchisor's operating methods and systems.

Default. A breach or violation of the franchise agreement by one of the parties.

Development Agreement. An agreement whereby a franchisor sells to a subfranchisor the exclusive right to establish, market, and/or sell franchises in a specific geographic area for a defined period of time, usually in accordance with a development schedule.

Encroachment. Action taken by a franchisor to invade the exclusive territory of a franchisee by selling products or services within the territory or opening franchisor-owned locations within the territory.

Federal Trade Commission (the "FTC"). An independent agency of the federal government consisting of five commissioners. The FTC is responsible for investigating and bringing enforcement actions against illegal business practices in interstate commerce.

Franchise Disclosure Document ("FDD"). The required disclosure document describing important aspects and details of franchise opportunities that must be given to prospective franchisees at least 14 days prior to the execution of any agreement or payment of money.

Franchise Fee. A sum of money paid by the franchisee to the franchisor, usually at the time the franchise agreement is signed. The initial franchise fee may cover a variety of expenses and services including training costs and assorted start-up costs as well as the right to use the franchisor's trademarks and business methods. This fee generally does not include inventory or equipment.

Good Cause or Reasonable Cause. A legal term that means having legally sufficient grounds to support the actions of a party to a franchise agreement, typically in the case of a franchisor's decision to terminate or not renew a franchise agreement.

Goodwill. The positive public reputation, trust, image, or loyalty which a franchisor has developed. A franchisor's goodwill cannot be accurately measured in monetary terms, but is often a franchisor's most valuable asset.

Multi-Unit Franchising. A type of franchise relationship where a single franchisee purchases two or more franchise locations from a franchisor.

Operations Manual. The confidential document detailing the trade secrets and operating methods of a particular franchise, including such topics as quality control requirements, required hours of operation, required operating procedures, recipes, product or service specifications, required uses and restrictions on the franchisor's trademarks and other intellectual property, and other operational issues related to the franchised business.

Subfranchising. A type of franchise relationship where one party (the "subfranchisor") enters into a master franchise agreement with a franchisor which provides that the subfranchisor is responsible for soliciting others (the "subfranchisees") to open new franchise locations within a specific geographic area. In some cases, the franchisor retains various rights and controls over the subfranchisees, but in other cases, most rights and controls over subfranchisees rest with the subfranchisor. Either or both the franchisor and the subfranchisor provide ongoing supervision and assistance to the subfranchisees.

Turn-Key Operation. A term used to describe a franchise package offered by a franchisor that comes fully equipped and all-inclusive so that a new franchisee practically needs only to "turn the key" to start a business.