Franchise Law and Legal Definition

A franchise has different meanings under the law. A franchise may refer to a right granted by the government to a person or corporation, such as a taxi permit, bus route, an airline's use of a public airport, business license or corporate existence. The right to vote in a public election is also referred to as a franchise. Franchise is also commonly used to refer to a grant of the right to operate and share in the profits of a business or sell goods or services under a brand or chain name. Franchise is defined, under 15 U.S.C. § 2801(1)(A)(i)-(iv), as "any contract between a refiner and distributor, a refiner and a retailer, a distributor and another distributor, or a distributor and retailer under which a retailer or distributor uses the trademark of an oil company in connection with the sale of motor fuel." Brewer v. Exxon Corp., 626 F. Supp. 76, 78-79 (E.D. Tenn. 1985) Franchise may mean the right one has to operate a store or sell goods or services under a franchise agreement. In a franchise business relationship, the owner (the franchisor) licenses others (the franchisees) to operate outlets using business concepts, property, trademarks and tradenames owned by the franchisor.

Franchising

Franchising is a kind of licensing arrangement wherein a business owner, known as the "franchisor," distributes or markets a trademarked product or service through affiliated dealers, who are known as "franchisees." While these franchisees own their establishments, terms of franchising agreements typically require them to share operational responsibilities with the franchisor.

Over the past few decades, franchising has emerged as an integral part of America's commercial landscape. Indeed, companies as diverse as McDonald's, The Gap, and Jiffy Lube owe their ubiquitous presence in the marketplace to the practice. Department of Commerce figures indicate that franchises exceeded $1 trillion in annual sales in the year 2000. The International Franchising Association (IFA) estimates that 40 percent of all U.S. retail sales took place in franchise outlets in the early 2000s. Although the U.S. Census Bureau has not counted franchises in previous Economic Censuses, International Franchise Association President Matthew Shay announced in a late 2005 press release that plans were being finalized by the Bureau to include questions about franchising in the 2007 Census of Business.

Franchising has been embraced by many entrepreneurs eager to run their own company. But the characteristics of a franchising business are dissimilar in some crucial respects from those of other start-up businesses. Some businesspeople have even gone so far as to characterize franchisees as glorified employees of the franchisor, the company that owns the trademark and business concept that the franchisees use. Other observers find this description of the relationship to be misleading and simplistic, but they also acknowledge that there are many aspects of franchising that a prospective small business owner should learn about before entering into such an agreement.

Three different kinds of franchising arrangements are commonly found in the United States today. Business format franchises are the most popular of the franchise types. Under this arrangement, the franchisee pays an initial fee and an ongoing royalty to the franchisor in exchange for a proven business operation and identity. Benefits of this package include the franchisor's name and its product line, marketing techniques, production and administration systems, and operating procedures. A second option is to pursue a product or trade name franchise in which the franchisee becomes part of a franchisor's distribution network. Some small business owners choose to combine their resources under the banner of a single operating network. These affiliate franchises are thus able to pool their assets together for purchasing, advertising, and marketing visibility purposes.

BENEFITS OF FRANCHISE OWNERSHIP

There are many significant advantages to franchise ownership. In most instances, an entrepreneur who decides to buy a franchise is purchasing a business concept with a proven track record of success. In addition, a franchise agreement provides instant name recognition for the business, which can be a huge advantage if the name enjoys a solid reputation in the marketplace. But franchising provides benefits in many other areas of business operation as well. These include:

Advertising and Promotion Franchisees benefit from any national advertising campaigns launched by the corporation with which they have gone into business. In addition, many franchisors provide their franchisees with a wide range of point-of-sale advertising materials, ranging from posters to mobiles to brochures. Since such materials are often expensive to produce, they would otherwise be beyond the reach of some individual franchisees.

Operations Franchisors provide franchisees with a wide range of help in the areas of administration and general operations. The entrepreneur who becomes a franchise owner is instantly armed with proven products and production systems; inventory systems; financial and accounting systems; and human resources guidelines. Many franchisors also provide management training to new franchisees, and ongoing seminar workshops for established owners.

Buying Power Franchisees are often able to fill inventory needs at discount prices because of their alliance with the franchisor, which typically has made arrangements to buy supplies at large-volume prices. This is an increasingly great advantage because today one has to compete with national chains, conglomerates, buying consortiums, and other large franchises. The small-business person who purchases in small quantities can not easily compete in terms of buying power. By becoming a franchisee, a business has the collective buying power of the entire franchise system.

Research and Development Most small business owners are able to devote little time or money to research and development efforts. Franchising, then, can provide a huge lift in this regard, for many franchisors maintain ongoing research and development systems to develop new products and forecast market trends.

Consulting Services It is in the franchisor's best interests to do all it can to ensure the success of all of its franchisees. As a result, the entrepreneur who decides to become a franchisee can generally count on a wide range of training and consulting services from the larger company. Such services can be particularly helpful during the startup phase of operations.

DRAWBACKS OF FRANCHISE OWNERSHIP

While the benefits of franchising are many and varied, there are well-documented drawbacks that should be considered as well. These include:

Cost The initial franchise fee, which in some cases is not refundable, can be quite expensive. Some fees are only a few thousand dollars, but others can require an up-front investment of several hundred thousand dollars. In addition, some franchisors require their franchisees to pay them regular royalty fees—a percentage of their weekly or monthly gross income—in exchange for permission to use their name. Some franchisors also require their franchise owners to help pay for their national advertising expenditures. Other costs include insurance, initial inventory purchases, and other expenses associated with equipping a new business.

Limited Control

Franchisees are subject to many franchisor regulations concerning various aspects of business operation and conduct. As the Federal Trade Commission (FTC) acknowledged to prospective franchisees in its *Consumer Guide to Buying a Franchise*, "these controls may significantly restrict your ability to exercise your own business judgment." Areas in which franchisors generally wield significant control include the following:

Site Approval—Many franchise agreements include stipulations that give the franchisor final say in site selection. Some franchisors also limit franchise territories, and while such restrictions generally prevent other company franchisees from impinging on your territory, they can also act to restrict your ability to relocate once you have become established.

Operating Restrictions—Franchise agreements include many instructions on the ways in which a franchisee must conduct business. These encompass all aspects of a business's operation, from operating hours to accounting procedures to the goods or services that are offered. "These restrictions may impede you from operating your outlet as you deem best," admitted the FTC. "The franchisor also may require you to purchase supplies only from an approved supplier, even if you can buy similar goods elsewhere at a lower cost."

Appearance Many franchisors cultivate a certain readily recognizable look to their outlets, for they know that such standards, when applied consistently, contribute to national recognition of the company name and its products and services. Franchisees generally accept these regulations willingly, for these standards of appearance in the areas of decor, design, and uniforms have proven to be part of a winning formula elsewhere. This is just as well, for the franchise owner who does wish to make changes in his business's appearance often has little freedom to do so.

Association with the Franchisor For the small business owner whose franchise is attached to a highly regarded, financially robust franchisor, the association can be a powerful positive in his or her business. Business experts note, however, that a franchise outlet can suffer severe damage if its franchisor is beset with financial difficulties or public relations problems. "If the franchisor hits hard times, you'll most likely feel them as well," noted the editors of the *Small Business Advisor*. "You are inevitably tied to the franchisor, not only by contract, but by concept, name, product, and services sold."

Prospective franchisees, then, need to weigh many factors in their decision making about entering the burgeoning world of franchising. But most small business consultants acknowledge that these factors usually boil down to a couple of fundamental concerns. The choice of becoming a franchisee or starting a stand-alone business hinges on the answers one gives to two important questions: Is risk sufficiently mitigated by the trademark value, operating system, economies of scale, and support process of the franchise to justify a sharing of equity with the franchisor? Is my personality and management style compatible with sharing decision-making responsibilities with the franchisor and other franchisees?"

SELECTING A FRANCHISE

It is imperative for prospective franchise owners to make an intelligent, informed decision regarding franchise selection, for once a contract has been signed, the franchisee has committed himself to the enterprise. But the selection process can be a bewildering one for the unprepared entrepreneur. Franchise opportunities are available in a wide array of industries, each of which offers its own potential benefits and drawbacks. Moreover, every franchisor has its own strengths and weaknesses. Several business areas, then, need to be investigated as part of any effective franchise selection process.

Analysis of Self

Experts counsel prospective franchise owners to evaluate their own personal strengths and weaknesses before signing any franchise contract. Prospective franchisees should also have an understanding of their ultimate business and personal objectives before beginning the search for an appropriate franchise. The entrepreneur who is most interested in achieving financial security may want to look in an entirely different industry than the entrepreneur who hopes to land a franchise that will enable him or her to devote more time to family life.

Analysis of Industry and Market

Prospective franchise owners need to evaluate which industries interest them. They also need to determine whether the franchisor's principal goods or services are in demand in the community in which he or she hopes to operate. Other industry-wide factors, such as the cost of raw materials used and the amount of industry competition, need to be weighed as well. The latter issue is a particularly important one, for it can be a fundamental factor in a franchisee's success or failure. The presence of some competition, for instance, often indicates a healthy demand for goods or services in that industry area. A dearth of competitors, though, might indicate that demand is low (or nonexistent). Similarly, the presence of several competitors might necessitate an examination of whether the market can support another provider in that area, or whether you might have to take meaningful market share from already existing businesses in order to survive.

Analysis of Franchisor

Entrepreneurs interested in franchising should be knowledgeable about the strengths and weaknesses of companies that offer such arrangements. Factors that should be considered include the franchisor's profitability, organizational structure, growth patterns, public reputation, litigation history, financial management capabilities, fee requirements, and relationship with other franchisees.

Perhaps the best source of information on these and many other issues is the franchisor's disclosure document. This important document, which must be given to prospective franchise owners at least ten business days before any contract is signed or any deposits are owed, usually takes the form of the Uniform Franchise Offering Circular (UFOC). The UFOC contains important information on key aspects of the franchisor's business and the nature of its dealings with franchisees. Information contained in the UFOC includes a franchise history; audited financial statements and other financial history documents; franchise fee and royalty structures; background on the franchise's leading executives; terms of franchise agreements; estimated start-up costs for franchisees (including equipment, inventory, operating capital, and insurance); circumstances under which the franchisor can terminate its relationship with a franchisee; franchisor training and assistance programs; franchisee advertising costs (if any); data on the success (or lack thereof) of current and former franchisee operations; and litigation history.

Some prospective franchise owners pay less attention to a company's litigation history than other information included in the UFOC, but a company's past litigation experiences can, in some cases, provide important insights into the franchisor's business ethics and/or operating style. "The disclosure document tells you if the franchisor, or any of its executive officers, has been convicted of felonies involving, for example, fraud, any violation of franchise law or unfair or deceptive practices law, or are subject to any state or federal injunctions involving similar misconduct," noted the Federal Trade Commission. "It also will tell you if the franchisor, or any of its executives, has been held liable or settled a civil action involving the franchise relationship. A number of claims against the franchisor may indicate that it has not performed according to its agreements, or, at the very least, that franchisees have been dissatisfied with the franchisor's performance. Be aware that some franchisors may try to conceal an executive's litigation history by removing the individual's name from their disclosure documents."

The inclusion of other information on a franchisor's business dealings with franchisees is up to the discretion of the franchisor. For example, while franchisors are required by law to provide prospective franchisees with documentation of expected start-up costs, they are not required to provide long-term earnings projections. Those who do provide such information are obligated by the FTC's Franchise Rule to have a reasonable basis for the claims they make and provide prospective franchisees with written information substantiating their projections.

It is important, then, to utilize other sources of information in addition to the disclosure document when pondering a move into the world of franchising. For example, small business consultants often urge prospective franchisees to conduct interviews with franchisor representatives about various business issues. Other sources of information often cited include financial institutions (for financial evaluations of the franchisor), state agencies (for information on franchisee rights in the state in which the franchisee is operating), the Better Business Bureau (for news of possible complaints against the franchisor), industry surveys, and associations (such as the Franchise Consultants International Association and the International Franchise Association).

Many experts also encourage prospective small business owners to interview current and former franchisees associated with the franchisor. Would-be franchisees can thus gain first-hand information on a great many business subjects, including: likely size of total investment, hidden or unexpected costs, satisfaction with franchisor performance (in training, advertising, operating, etc.), franchisee backgrounds, and business trends in the industry. Franchisee lists can be a valuable resource, but consultants caution their clients to make certain that they receive a complete list, rather than a list of selected franchisees who are compensated by the franchisor for giving positive appraisals of the company.

FRANCHISING LAWS

The United States has developed an extensive regulatory system designed to govern franchising practices throughout the business world. Chief among the federal guidelines are the FTC's Franchising and Business Opportunity Ventures Trade Regulation Rules and Subsequent Guidelines. In addition, many state governments have fashioned pieces of legislation that directly impact on franchising operations. A good many of the laws governing franchising—both at the state and federal level—are expressly designed to protect prospective small business owners from unscrupulous franchisors who misrepresent themselves.

Franchising experts commonly urge prospective franchisees to enlist the help of an attorney during the franchise selection process. Indeed, since franchising is such a complicated business, many entrepreneurs secure an attorney's services throughout the process. Legal assistance is especially helpful when the time comes to sign the franchise or license agreement, the document that lays out the terms of the partnership between a franchisee and a franchisor. "The franchise agreement is the foundation on which your franchise is built," stated the *Entrepreneur Magazine Small Business Advisor*. "The agreement gives both parties a clear understanding of the basis on which they are going to continue to operate."

The franchise contract covers all aspects of the franchisee-franchisor agreement, from record keeping to site selection to quality control provisions. The contract is designed to cover both relatively minor issues—such as sign display requirements—to matters of major importance—such as the franchisee's schedule of royalty payments and required insurance provisions. Franchise agreements also include a section devoted to detailing the length of the contract, and any possibilities for extending the terms of the contract beyond the termination date. Long term agreements (15 years or more) give franchisees more security, though this can be problematic if their relations with the franchisor take a bad turn. Since shorter terms do make it easier for franchisors to rid themselves of under performing or troublesome franchisees, some prefer to go this route. Others, however, place a higher value on securing the franchisee royalties that often pour in under the longer agreements.

Information included in the franchise contract includes the following:

- Accounting and recordkeeping provisions
- Existence (and terms) of any performance quotas
- Fairness of the franchise fee
- Fairness of the royalty arrangement
- Franchisor's continuing services to franchisee
- Insurance protection (if any) under franchisor's patent or liability insurance coverage
- Operating provisions (including quality control, human resource management, and other areas)
- Restrictions (if any) on business activities outside the franchise
- Restrictions (if any) on selling the franchise
- Start-up investment required
- Termination or default terms (as well as arbitration clauses)
- Terms of contributions, if any, to parent company's national advertising campaigns
- Terms of inventory and ordering practices
- Terms of renewing the franchise agreement
- Territorial protections

Given the scope of its coverage—and its importance as the binding legal document between franchisee and franchisor—the franchise contract is, in its final form, an imposing and complicated document. Again, the importance of the agreement makes it imperative that prospective franchise owners consult with an attorney before signing the contract.