The ABC's Of FRANCHISING

A Cohesive and Concise RoadMap to the Ins and Outs of Franchising

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WHAT IS FRANCHISING?

There are many definitions of a franchise. They all essentially describe a comprehensive relationship in which one party (the franchisor) grants to another party (the franchisee) the right to operate a business selling products and/or services produced or developed by the franchisor, under the franchisor's business format and identified by the franchisor's trademark.

Part I: Introduction to Franchising

What is Franchising?

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Franchising can also be thought of as a pooling of resources and capabilities. The Franchisor contributes the initial capital investment, know-how and experience and the franchisee contributes the supplemental capital investment, motivated effort and operating experience in a variety of markets. A modern franchise includes a format for the conduct of a business, a management system for operating the business and a shared trade identity.

Franchising is a business method and relationship, not an industry. Franchising is the predominant business relationship in many industries and business segments and is becoming more common in others. The industries and types of businesses utilizing franchising as a method of distribution are varied, however can be found most comprehensively in the International Franchise Association ("IFA") publication entitled, "Franchise Opportunities Guide." Franchising is a comprehensive business relationship, not just a buyer-seller relationship. There is considerable interdependence between the franchisor and the franchisee.

Origins of Modern Franchising

Modern franchising began with the development after the First World War of gasoline service stations and automobile dealerships. The growth of franchising into the economic force it has become began after the Second World War and has paralleled growth in service industries since 1945.

Importance of Franchising

Currently in the United States, franchising not only constitutes more than 50% of all retail sales, but there are more than 2,500 franchising companies and nearly 800,000 franchisee and franchisor operated outlets. These franchising companies and their franchisees employ more than 8,800,000 persons. Working in a franchised business is the first job for many young people today.

Franchising is growing in significance in other countries. Franchising is already a strong economic force in Canada, Japan, Western Europe, Pacific basin countries and Australia. Franchising is developing in Mexico, Brazil, Argentina, Chile, South Africa, Turkey, Saudi Arabia, United Arab Emirates, Kuwait, Indonesia, Malaysia, Poland, Czech Republic and Hungary. It is likely that franchising will develop in the next century in China, India, Pakistan, Russia, other countries of Asia, South America and East Europe and Africa.

Types of Franchise Relationships

In the product distribution franchise, the franchisor typically is a manufacturer selling a finished or semi-finished product to a franchised dealer. The franchised dealers are willing to furnish presale and post-sale service to customers, concentrate on the sale of the franchisor's products and refrain from selling competitive products. There is substantial interdependence between the franchisor and its franchised dealers.

In the business format franchise, the franchisor licenses a business format, operating system and trademark to its franchisees and may or may not sell tangible products to them. Examples of business format franchising are found in food service, lodging services, automobile maintenance (e.g., muffler and brake replacement, tune-up, oil change, cleaning and waxing), convenience stores, automobile and truck rental, business services (e.g., bookkeeping, accounting, temporary and permanent employment) and consumer services (e.g., home cleaning and repair, lawn care, day care and educational services for children, tax return preparation and real estate brokerage).

Conversion franchising is considered a separate type of franchising because it involves the conversion of independent dealers or unaffiliated businesses to franchises. Existing businesses are willing to surrender some degree of independence and agree to pay fees in order to gain a stronger trade identity, regional and national marketing and the economic advantage of combined purchases of goods and services. The best examples of conversion franchising are the real estate brokerage networks (e.g., Century 21, RE/Max and Coldwell Banker).

Components of a Franchise Network

A franchise network consists of a franchisor (the grantor of the franchise) and one or more types of franchisees (the operator of the franchised business).

The most common type of franchisee, usually called a "single unit franchisee", owns and operates from one to three franchised businesses. Typically, the franchises for these businesses were acquired at different times.

The second type of franchisee is called an "area franchisee." There are two general types of area franchises, a "development franchise" and a "master franchise." The development franchise grants to the area franchisee the right to develop and operate a specific number (or an unlimited number) of franchised businesses located within an exclusive territory. The franchisee typically commits to develop a minimum number of businesses during each development period (usually a one year period), referred to as a development quota. The development franchisee signs a separate unit franchise agreement for each such business.

The master franchise differs from a development franchise primarily with respect to the rights granted by the franchisor to the master franchisee to grant sub-franchises to third parties to develop and operate the franchised business within the master franchisee's exclusive territory. In some master franchise relationships, the unit franchise agreement is signed by all three parties - the franchisor, the master franchisee and the sub-franchisee. However, in most networks, the sub-franchise agreement is between the master franchisee and the sub-franchisee and the franchisor has no direct contractual relationship with the sub-franchisee and only such rights vis-à-vis the sub-franchisee as are reserved in the master franchise and sub-franchise agreements. The master franchisee charges fees to the sub-franchisees and pays a portion of those fees to the franchisor. Though master franchising has been used effectively by several franchisors to develop franchise networks in the United States, the master franchise relationship is more common in international franchising.

Several franchisors have developed a category of franchise relationship, sometimes referred to as an area director, in which a person is granted rights to develop a territory by soliciting the sale of franchises on behalf of the franchisor and locating sites for the establishment of franchised businesses. The area director may also have responsibility for training, continuing assistance and quality control supervision of the franchisees in his area. The area director has a contractual relationship with the franchisor, but not with the franchisees. The area director generally receives a portion (1/4 to 1/3) of the initial franchisee fee paid by the franchisee and a similar share of the continuing fees paid by the franchisee. The area director structure has elements of single unit franchising, development franchising and master franchising. It has been used effectively by several franchising companies (e.g., Subway) to rapidly expand their networks.

OTHER RELATIONSHIPS OF FRANCHISORS AND FRANCHISEES

The franchise relationship is actually a composite of several relationships. The franchisor is a supplier of intellectual property, granting to the franchisee the right to use trademarks, trade dress, confidential information, a business format and an operating system. The franchisor is a trainer of and an advisor to the franchisee. Generally, the franchisor furnishes marketing services to its franchisees by collecting and pooling advertising contributions and administering a marketing program that develops advertising and marketing programs and materials and conducts market research and public relations. Finally, franchisors supply research and development services to their franchisees.

In addition to these typical relationships, franchisors and their franchisees frequently have additional relationships. In some franchise networks, the franchisor will be the franchisee's landlord, either leasing to the franchisee a site owned by the franchisor or subleasing to the franchisee a site that the franchisor has leased. Generally, only large, well-financed franchisors are able to act as landlords to their franchisees and this relationship is most common in food service and in franchise networks that lease sites in regional malls (where the franchisor will usually be a more acceptable tenant).

Some franchisors, as manufacturers or wholesalers, supply equipment to their franchisees. Franchisors also sell finished products to their franchisees for resale (e.g., automobiles, computers, gasoline, and inventory carried by convenience stores) or supply components and ingredients that the franchisee uses to make a product and/or perform a service (e.g., food products for a food service business and parts for an automotive repair business). The franchisor may be the exclusive supplier of certain equipment and products or merely an approved supplier along with other suppliers from whom franchisees may purchase. The franchisor may serve or act as a supplier entirely for quality control or trade secret protection purposes, or to establish a convenient and low cost supply source for its franchisees (charging only small mark-ups on goods sold to franchisees and relying on fees for its franchising revenue) or may structure its supply program as a profit center (in lieu of or in addition to fee revenue).

It has become more common in recent years for franchisors to be a direct or indirect source of financing for their franchisees. Financing may be provided directly, indirectly through general or limited guarantees or inventory buy-back arrangements with third party lenders, by leasing a business facility to the franchisee or by other means. In some cases, the franchisor will receive rights to buy equity interests in the franchisee's business as part of the consideration for loans made to the franchisee. Generally, only larger franchised networks are able to develop financing programs for their franchisees. Such networks use franchising primarily to put in place highly motivated owner-managers in their retail outlets and only secondarily for the capital contributions that franchisees make to network expansion.

Alternative Methods to Expand a Business

Franchising is certainly not the only method for expanding a business. Though franchising offers some unique advantages over other methods, no company should decide to develop a franchise expansion program without first considering other methods.

Company-Owned Outlets

The most commonly used alternative is the development of additional outlets owned and operated by the company. This form of expansion gives a company somewhat greater control over the development of its network and higher revenues from each outlet that it opens (assuming they are profitable), but it has several disadvantages. First, the company will need to raise substantial capital to expand its network. For example, if each outlet requires capital of $100,000, then 100 outlets will require a capital investment of $10 million. A small company is able to acquire that amount of capital only over an extended period and frequently is required to sell a substantial part of its ownership to Second, a company growing its network with owned outlets will face two distinct manpower problems: 1) finding sufficient outlet managers and field service staff to supervise its outlets; and 2) devising compensation programs to motivate managers. A number of companies require outlet managers to make an investment to secure an outlet managerial position and compensate them with both a base salary and a share of outlet profits or cash flow. Such compensation structures undoubtedly enhance the motivation of managers, but it is doubtful that they equal the motivation enhancement inherent in the risk and reward characteristics of ownership of a business as a franchisee.

Joint Ventures

A business may also be expanded by developing joint venture relationships. Two types of joint ventures can be used. In one type, the sponsoring company manages each outlet and the joint venture partner is a passive investor that contributes capital. Many such relationships are found in the lodging industry. The hotel management company contributes know-how, development plans, its reservation system, its trademark and management services, and its joint venture partner(s) contributes capital to develop, equip and staff the hotel and operate it until it produces a positive cash flow. The hotel management company will generally receive a base fee and will share profits with the joint venture partner(s).

In a less common form of joint venture, the sponsoring company acts as a passive investor, furnishing capital for outlet development, along with its joint venture partner. The latter has responsibility for the management of the outlet. This relationship differs from a company-owned outlet whose manager shares in profit or cash flow only in that the joint venture manager will have an actual ownership interest in the outlet he manages, not just a compensation package that includes a share of profits.

Independent Dealerships

Some companies can effectively expand their distribution network with nonexclusive, independent dealerships (or distributorships). Such dealerships may carry other, including competitive, products and the network will not have the degree of interdependence found in a franchise network. This type of distribution network is suitable for a manufacturer, particularly a producer of a relatively low cost product with minimum pre-sale and post-sale services, or a product that consumers are used to buying at a retail outlet that carries multiple brands of the same product (e.g., appliances). For such products, a wide range of distribution outlets may be the best marketing strategy. Non-exclusive, independent dealers are rarely utilized for the distribution of a service.

Member-Owned Cooperative Associations

Member-owned cooperative associations are found in the grocery and hardware store industry and in bedding products manufacturing. A member-owned cooperative would be an alternative structure to a conversion franchise. Cooperatives are difficult organizations to manage because members of the board of directors have potentially conflicting interests: the interests of the cooperative and its members and the interests of their individual businesses. Cooperatives are also subject to more stringent antitrust rules than are franchised networks.

Part II: Franchising As A Superior Expansion Method?

FRANCHISING AS A SUPERIOR EXPANSION METHOD

The benefits of franchising as a method of business expansion fall into two general categories: (1) benefits relating to the capital investment furnished by franchisees to expand the network and (2) the motivated management by franchisees of the businesses in which they have made substantial investments. These benefits are enhanced by the interdependence that exists in the franchise relationship.

PART II: FRANCHISING AS A SUPERIOR EXPANSION METHOD

These benefits are enhanced by the interdependence that exists in the franchise relationship. The franchisor needs its franchisees to expand its network and enhance its trademark and the franchisees need essential services and support from their franchisor to be competitive and operate profitably. Franchising also offers psychological benefits to an entrepreneur that conceives an idea for a business, develops that idea in one or more prototypes and then expands the business into a regional or national network of similar business operated by independent owners.

BENEFITS RELATED TO CAPITAL FURNISHED BY FRANCHISEES

RAPID EXPANSION OF DISTRIBUTION SYSTEM

Franchising enables a company to establish a large number of business outlets in a relatively short time period. The capital and much of the work to locate and acquire sites and develop outlets is supplied by the franchisee. In most situations, a franchisor does not have the asset base or business experience to raise the amount of capital that will be furnished by its franchisees to expand the franchise network. Such a company might be able to raise additional capital periodically for expansion (as long as the great majority of its outlets were profitable), but its growth rate would be severely constrained. It is the unique opportunity offered by franchising, for an individual to own a business that is part of a network of similar businesses, that motivates such individuals to offer substantial amounts of capital for the expansion of a franchise network. If good locations for outlets are not abundant and are being sought by competitors, rapid expansion of a network enhances its chances of acquiring good locations and thereby acquiring market share at a faster rate. Rapid expansion builds consumer recognition and understanding of the product or service sold by the franchise network and creates recognition and value of the network trademark and consumer expectation of uniform quality at network outlets.

FRANCHISEES SHARE RISK OF EXPANSION OF THE FRANCHISOR'S NETWORK

Franchisees furnish most of the capital required to expand the franchisor's network. The franchisee furnishes equity and borrowed capital to pay for real estate, leasehold improvements, equipment, fixtures, furnishings, inventory and working capital required to establish the franchisee's outlet. In addition, the franchisee pays the franchisor a fee for the grant of the franchise that is usually set at a level that will cover most or all of the franchisor's cost of franchisee selection, training and pre-opening assistance. The franchisor's cost of expansion is usually limited to the overhead costs associated with franchisee recruitment, training and pre-opening assistance that are not covered by initial franchise fees.

Continuing fees paid by franchisees support advertising and marketing programs (which enhance recognition and goodwill of the franchisor's trademark), product and service development and expansion of the franchisor's network.

A franchising company is less vulnerable to cyclical fluctuations and outlet failures. Changes in fee revenue due to the fluctuation of sales of franchised outlets will be significantly less than fluctuations of profits at franchisor-owned outlets. A failing franchisee has a lesser financial impact than a failing company-owned outlet

A FRANCHISING COMPANY CAN REALIZE A HIGHER RETURN ON ITS INVESTED CAPITAL

Because the investment in the development of outlets is typically made by franchisees, a franchisor is able to operate with few fixed assets other than the outlets that it owns. Therefore, though its revenue from franchised outlets (composed of fees and product sales to franchisees) is substantially lower than it would be from owned outlets, a higher percentage of the revenue is profit and that profit is generated with a much lower capital investment.

Franchised Networks Can Realize Economies Achieved by Company-Owned Outlets Through Joint Procurement

Franchisors frequently develop supply programs for equipment, fixtures, furnishings, signs, supplies, insurance, marketing and advertising services and public relations services required by their franchisees. Such programs can furnish to a franchise network the advantages of combined purchasing power enjoyed by a network of company-owned outlets.

Reacquisition of Franchised Businesses

A successful regional or national franchisor, particularly if its capital stock is publicly traded, is in a position to buy back franchisee-owned businesses to expand the number of franchisor-owned and operated businesses in the network. Most large franchise networks consist of both franchisor and franchisee-operated businesses. In some cases, the franchisee will become a senior manager of the franchisor following the acquisition of his businesses.

Motivated Management of Franchisees

Franchising Can Be a More Effective Relationship Than Company-Owned Retail Outlets Operated by Managers or Independent Dealers

In a franchise network, the business plan is executed by business owners, not employed managers. An owner-manager is usually a more motivated and effective manager than a manager who has no investment in the business he manages and is compensated by a salary and a bonus. A franchisee has a direct and continuing financial interest in his business. A salaried manager does not have a comparable interest. An independent dealer does not have a predictable interest.

A dealer may sell several product lines and a particular supplier may not represent his most important product. The lesser interdependence between a supplier and a multi-line dealer makes the relationship less secure.

The intensity of franchisee owner-management reduces labor costs and results in other economies in operation. Outlets that cannot be profitably operated as company-owned outlets (i.e., at a rate of return exceeding the company's cost of capital) may operate profitably under the owner-management of

franchisees. Franchising makes it possible for the network to reach smaller markets because an owner-managed outlet can operate more efficiently than a company owned outlet, and a business with an owner-manager can be profitable with a smaller population base.

A franchised business owner constitutes a higher level of representation in his market, generally having a greater involvement with customers and community. Franchising can result in better pre-sale and post-sale customer service and product support. Customers will generally prefer doing business with the business owner. Thus, franchising can result in greater brand prominence at the retail level.

Franchisees Are Idea/Information Resources to a Franchisor

An owner-manager has a higher level of motivation to innovate. Franchisees are a productive source of new products, services, operating methods and marketing concepts. If a franchise network is structured to collect, evaluate and disseminate throughout the network the operational experience and innovative ideas of franchisees, the franchisor and all franchisees will benefit.

A Franchising Company Has a Simpler and More Efficient Management Structure

A franchisor is an administrator and service provider, furnishing information and other services to its franchisees. The operating responsibilities of its management are reduced. A franchisor's management is able to direct its attention and energies to long-term strategic planning.

A franchisor needs fewer levels of management. Fewer field supervisors are required to assist and inspect franchisees than are required for company-owned outlets. A franchisor's revenue is based on gross sales of franchisees, which are easier to monitor than retail outlet profits. The problems of hiring, training, motivating and retaining competent employees are shifted to franchisees.

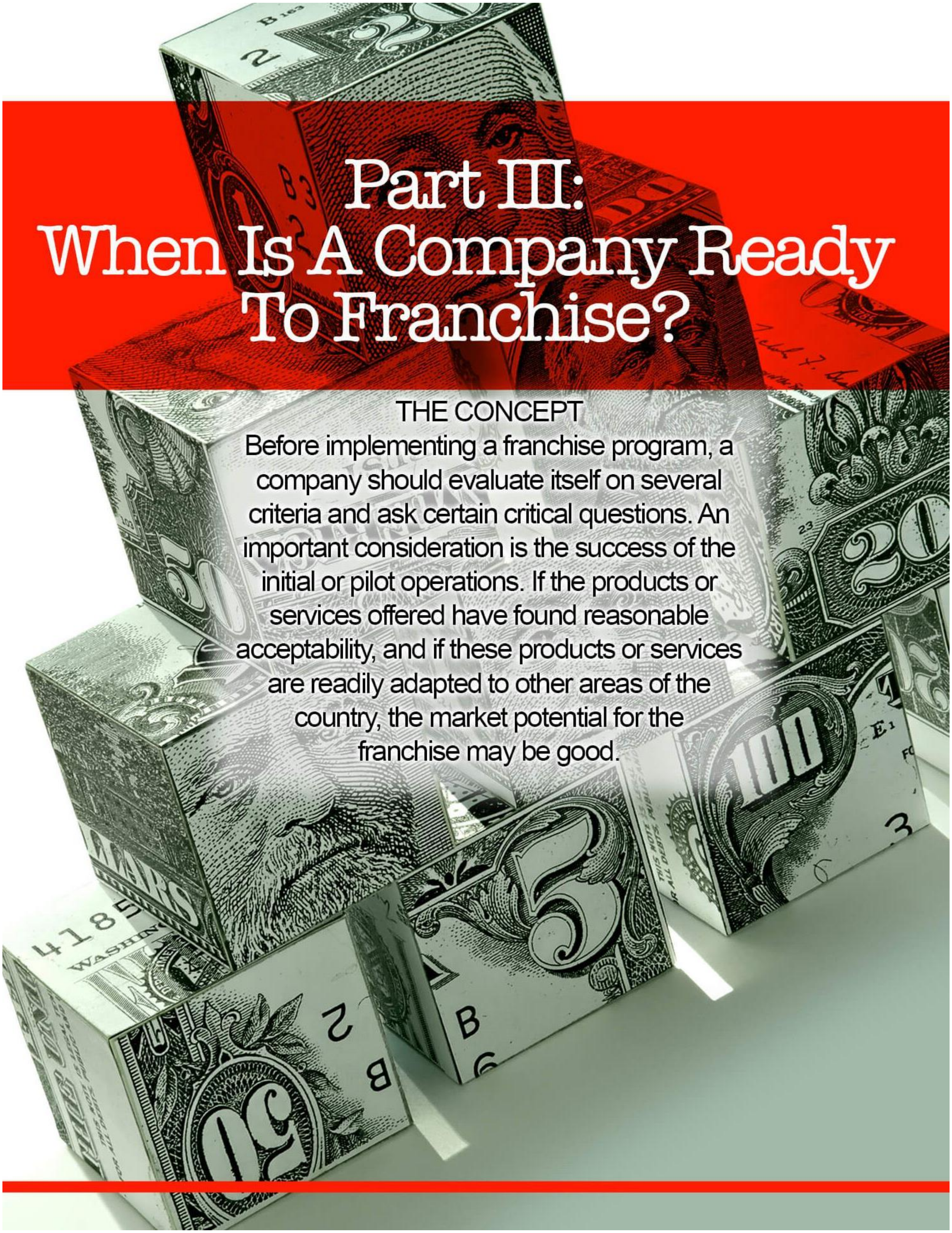
Franchising Offers Opportunities for Employees to Acquire Franchises

Franchisors can offer franchises to experienced employees and thereby reduce the "dead end job" syndrome and motivate employees that have reached their highest likely management level. The opportunity to acquire a franchise may prevent the loss of experienced managers to competitors. Experienced employees frequently make productive franchise owners. Some franchisors offer special incentives to their employees, such as reduced initial franchise fees and financing of an employee's investment to develop his franchised business.

Psychological Benefits

In addition to the significant benefits related to franchisee capital investment and motivated management, franchising offers psychological benefits to the entrepreneur that creates and builds a franchise network. Psychological benefits are the satisfaction that some persons derive from teaching and assisting others to successfully establish and operate a business that the network founder conceived and developed. Not everyone will consider such benefits to be important. Some will scoff at the idea, saying that franchisees are, at best, difficult to help and control, and that franchising has an aggravation factor that is a negative feature. There are many examples of both experiences.

Though some founders of a franchise network might not characterize their relationships with franchisees to have been generally positive, the founders of most franchise businesses that have successfully grown into regional and national networks would agree that there is great satisfaction in working with people building successful businesses who are also helping the franchisor become a successful company. A person who does not believe that he or she would derive such satisfaction should probably not consider franchising as a method of business expansion.



Part III: When Is A Company Ready To Franchise?

THE CONCEPT

Before implementing a franchise program, a company should evaluate itself on several criteria and ask certain critical questions. An important consideration is the success of the initial or pilot operations. If the products or services offered have found reasonable acceptability, and if these products or services are readily adapted to other areas of the country, the market potential for the franchise may be good.

PART III: WHEN IS A COMPANY READY TO FRANCHISE?

Does the company have a marketing niche that can be used to its advantage? Is the business similar to many others in a crowded business segment and, if so, is there a targeted customer base so that advertising and selling can be focused effectively?

It is important to note that to be successful, a franchisor must have some degree of distinctiveness, or the potential to achieve distinctiveness, in its business segment. If it does not, it will have difficulty attracting high caliber franchisees in an increasingly competitive market for such persons. A franchise may be distinctive in terms of its products, services, operating and delivery systems or marketing. If a business is to be successfully expanded by franchising its success must be attributable to its products or services, business format, operating or management systems and/or marketing. It cannot be attributable merely to the unique character of its founder, its management or its location. The elements of the success of the business must be teachable to persons with capabilities that exist among prospective franchise buyers and must be replicable by such persons. To be successful, a franchised business must appeal to high caliber franchise buyers and compare favorably with other franchises.

The investment requirements of the business must be realistic and the potential for a return on the cash and total investment should be appropriate to the risk inherent in the type of business. Any operating, marketing and financial problems should be addressed and solved, for the franchisee must receive a tested and refined business format.

PROFITABLE PROTOTYPES

A critical phase of the development of a franchise program is the creation of prototype businesses to test and refine the concept of the business to be franchised. In its prototype businesses, a prospective franchisor can test operational systems and controls, decor, designs, layouts, equipment, training methods, advertising and marketing programs, products and services, job requirements and descriptions, financial models, etc. The prototype is a laboratory at which problem areas can be identified, enabling the company to develop solutions and truly see if the business can be franchised. Before franchising, a company should have been operating outlets successfully at least at one, and preferably several, locations to verify the viability of the business and its profitability. A minimum period of time to test the pilot outlet(s) would be one year to take into consideration seasonal factors and to ensure that the business is producing attractive results. Two or three years of actual experience gained from the operation of existing outlets is ideal.

The business to be franchised must be capable of producing a reasonable return on the franchisee’s investment, after deducting the value of the franchisee’s labor. If a franchisee is merely buying a job, his motivation and loyalty to the network may be short lived. The business must also be able to generate sufficient revenue to the franchisor. A franchisor can capture only a portion of the gross revenue of a franchised outlet through continuing fees and the gross profit realized on sales of goods and services to the franchisee. If a business cannot generate a sufficient rate of return on the franchisee’s investment and sufficient revenue to support essential franchisor services and a sufficient profit to the franchisor, the business is a poor candidate for successful franchising.

EXPERIENCED PERSONNEL

A company that decides to expand by franchising must have a clear understanding of how it will recruit, train, communicate with and support franchisees. To fulfill these requirements, its staff resources, talents and abilities need to be identified. If necessary, its management personnel should receive additional training in essential management skills or additional or substitute managers should be hired.

A franchising company will be guiding and assisting a network of independently owned and operated business rather than managing the day to day operations of those businesses. Its staff will function as consultants to its franchisees and must possess certain specific skills: planning, leading, organizing, controlling, team building, decision making, problem solving and delegating. Specifically, a franchisor's staff needs to select qualified franchisees; to be knowledgeable about the franchisor's business and industry; to be good trainers; to have the ability to motivate; and to have the commitment to solve franchisee problems and cultivate positive franchise relationships.

A Protectable Trademark

Until relatively modern times a trademark was a type of intellectual property that was deemed usable only by its owner to identify the products he produced. This restrictive view of trademarks began to change in the early twentieth century. The trademark assumed a broader function, as a symbol of a specific type of product and level of quality that could be used by the owner and its licensee. This concept of a trademark was codified in the United States Federal Trademark Law in 1946.

The recognition of trademark licensing as a legally valid use of a trademark and the expansion of trademarks to include services (service marks) were fundamental predicates for modern business format franchising.

An important element of valid trademark licensing is the licensor's obligation to control the quality of its licensee's products/services. Absent such control, licensing can lead to abandonment of the trademark.

The licensed trademarks are the common trade identity of the network. The Franchisor acquires the goodwill value created by its franchisees' usage of the franchisor's trademark. Such goodwill value is rarely a significant balance sheet asset of a franchisor, but it can nevertheless be an extremely valuable asset.

There are three categories of trademarks. Coined or fanciful words and symbols are the strongest marks. Marks in this category can be a meaningless collection of letters or a recognized word unrelated to the products or services it identifies. Examples of coined and fanciful marks are:

Suggestive terms are relatively strong marks. Such a mark suggests a characteristic or feature of the seller's goods or services, but does not describe the goods or services. Examples of suggestive marks are:

- Coppertone (for sun tan oil)
- Cyclone (for wire fence)
- Gobble (for processed turkey meat)
- Habitat (for home furnishings)
- Marriage Proponents (for prospective marriage partner services)
- Maternally Yours (for maternity clothing store)
- Playboy (for magazine)
- Rapid-Shave (for shaving cream)
- Roach Motel (for insect trap)
- 7-Eleven (for food store chain)
- Sneaker Circus (for retail shoe store)
- Tail Wagger (for dog food)
- Tie Rak (for ties and accessories)

Descriptive terms are the weakest type of trademark and are difficult to protect. A descriptive mark actually describes the goods or services sold under the mark. In addition, surnames and given names, geographic designations and words used for their ordinary meaning are deemed descriptive. The line of demarcation between a suggestive mark and a descriptive mark is imprecise and involves a

subjective judgment. Examples of trademarks held to be descriptive are:

- America's Best Popcorn (for popcorn)
- Beef & Brew (for restaurant)
- Bufferin (for buffered aspirin)
- Consumer Protection Plan (for auto repair insurance)
- Continuous Progress (for educational materials)
- FashionKnit (for sweaters)
- 5 Minute (for glue which sets in five minutes)
- Holiday Inn (for motel)
- Homemakers (for family housekeeping services)
- Hour After Hour (for spray deodorant)
- Joy (for perfume)
- Steak & Brew (for restaurant)
- Vision Center (for optical clinic)

Descriptive trademarks cannot be registered on the Principal Trademark Register of the United States Patent and Trademark Office ("USPTO") without proof of secondary meaning. Secondary meaning is established by evidence that the trademark has become distinctive. A mark is distinctive when the public understands it to mean a specific brand or source (e.g., a franchise network) for a product or service, not merely a type of product or service. U.S. trademark law contains a presumption of distinctiveness after five years of continuous use. Distinctiveness may be demonstrated after a shorter period of use based on extensive development of a franchise network that uses the mark or extensive advertising and use. When a descriptive mark is used, there is a greater likelihood that others will use and gain local and regional rights to the mark before it becomes distinctive and registration may be granted.

Generic and common descriptive words do not acquire trademark rights but may be used as part of a trademark that contains other words or symbols that may function as a trademark.

A franchisor should select a trouble-free and registrable mark. Selecting such a mark involves trademark searches and a determination of the rights of other users of the same or a similar trademark. A search for potential conflicts is important because users of the same or a similar mark will have priority in their zone of use even if the franchisor's mark is ultimately registered on the Principal Trademark Register of the USPTO. If there are a large number of local usages, there will be many markets within which the franchisor will be unable to operate or franchise under its primary trademark. A franchisor should avoid a trademark if another company may have superior national or regional rights.

A franchisor should attempt to register its marks on the Principal Trademark Register. A company may apply for registration based on intent to use a mark or on the basis of actual use. Registration on the Principal Register constitutes constructive notice of use and a nationwide claim of rights to a mark and confers on the registrant superior rights to the mark vis-à-vis any user whose use commences after the mark is registered. If the application to register a mark is based on intent to use, and the mark is ultimately registered, the constructive notice is effective from the date of the application.

Sufficient Capital to Develop and Implement Its Franchising Program and Solve Operating Problems

Capital is required for many essential elements of a franchised network, including: (1) developing, operating and modifying prototypes of the business to be franchised; (2) developing and improving operating systems, products and services; and (3) developing the network trade identity (i.e., trademarks and trade dress). A franchisor will incur substantial expenses for: (1) consulting, legal and other professional services; (2) hiring and training management and field personnel; (3) marketing and advertising; (4) compliance with the regulation of franchise sales; (5) selling franchises; and (6) performing services for and assisting franchisees. A franchisor that is dependent upon initial fees paid by franchisees to cover its operating costs will be under pressure to sell franchises, without regard to the qualifications of the buyer, and to expand in remote areas, where the franchisor may be unable to effectively monitor and support a franchisee.

Part IV: Buying A Franchise

THE REGULATION OF FRANCHISING

A series of laws have been enacted to regulate various aspects of franchising. These laws were the result of a public policy debate that began in the early 1970's to combat alleged abuses in franchising. These laws regulate franchisor conduct before the sale of the franchise, during the term of the relationship and upon termination of the franchise. If a commercial relationship falls within the definition of a "franchise" as set forth in these laws, it will be subject to a variety of legal requirements and restrictions. Failure to comply can result in lawsuits by private parties and/or penalties, civil fines, injunctions and even criminal prosecution by a government authority.

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Federal Regulation of the Sale of Franchises

At the federal level, on October 21, 1979, the Federal Trade Commission issued a Trade Regulation Rule (the "Original FTC Rule" or "FTC Rule") requiring, among other things, disclosure of specified categories of information to a prospective franchisee. However, beginning on July 1, 2008, franchisors were required to comply with the Amended FTC Franchise Rule entitled, "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities" ("Amended FTC Franchise Rule" or "FTC Franchise Rule"). The Amended FTC Franchise Rule maintains the benefits of the Original FTC Franchise Rule, preventing unfair and deceptive practices identified in the original rulemaking through pre-disclosure of material information necessary to make an informed purchasing decision and prohibition of specified misrepresentations.

Under the FTC Franchise Rule a commercial business arrangement is a "franchise" if it satisfies three definitional elements. Specifically, a 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 6 months of operations.

The FTC Franchise Rule defines a prospective franchisee as any person (including any agent, representative, or employee) who approaches or is approached by a franchise seller to discuss the possible establishment of a franchise relationship. These disclosures must be made to a prospective franchisee at least fourteen (14) calendar days prior to the execution of any franchise document or the payment of any consideration for the franchise. By requiring the franchisor to provide this information, the FTC Franchise Rule is intended to reduce the prospective franchisee's investigative costs by providing comprehensive materials about the franchise and the franchisor, enabling the prospective franchise buyer to make comparisons with other franchise offerings. A second goal of the FTC Franchise Rule is to discourage high-pressure sales tactics and to provide the prospective purchaser with a "cooling-off" period before returning any signed documents or making any payments to the seller.

Application of the FTC Franchise Rule

Only if a relationship meets all of the jurisdictional elements of a franchise will the requirements of the FTC Franchise Rule apply. These elements are as follows:

- the offer, sale or distribution of goods, commodities or services by a business (the "franchisee");
- the identification or association of the franchisee's business with a trademark, service mark, trade name, advertising or other commercial symbol of another person (the "franchisor"); or requirements that the franchisee meet quality standards in connection with the use of the mark or symbol;
- significant control by the franchisor over the business operation of the franchisee, or significant assistance by the franchisor to the franchisee (the FTC Franchise Rule enumerates certain controls and assistance, any one of which will satisfy this standard, including site approval, hours of operation, production techniques); and
- direct or indirect initial payment or commitment to make an initial payment by the franchisee to the franchisor, as a condition of obtaining or commencing the franchise operation, of $500 or more at any time before or within the first six (6) months of the relationship.

This definition of a franchise, in application, is quite broad. Anytime payment of $500 or more is made to enter into a commercial relationship associated with a trademark or service mark where the seller asserts some form of control over or assistance to the business operation, a franchise within the meaning of the FTC Franchise Rule probably exists. However, the Franchise FTC Rule does not cover pure product distribution arrangements where the

Exemptions from the FTC Franchise Rule

Even if a commercial relationship meets the FTC Franchise Rule's definition of a franchise, the seller of the relationship may not be subject to the FTC Franchise Rule's disclosure obligations if the commercial relationship falls within one of the following specific exemptions to the FTC Franchise Rule:

Fractional Franchises.
A fractional franchise relationship exists when an established distributor adds a franchised product line to its existing line of goods. To be exempt from the FTC Franchise Rule, the franchisee must have more than two (2) years' prior management experience in the same business as the franchise, and the proposed relationship must be anticipated to represent no more than twenty percent (20%) of the dollar value of the franchisee's projected gross sales during the first year of operation.

Leased Departments.
The FTC Franchise Rule exempts arrangements by which an independent retailer sells goods or services from the premises of another, larger retailer, but only if the larger retailer does not restrict the "lessee's" sources of supply.

Minimal Investments.
The FTC Franchise Rule exempts from its disclosure requirements sales of franchises where the "initial" required payment within six (6) months after commencing operation of the franchised business is less than $500.

Oral Agreements.
The FTC Franchise Rule exempts purely oral relationships that lack any written evidence of a material term of the franchise relationship or agreement, as a matter of policy, to avoid problems of proof in its enforcement. However, the exemption does not apply when there is any writing, even if unsigned, with respect to a material term, such as a purchase of goods or equipment.

Petroleum Marketers and Resellers.
The FTC Franchise Rule exempts petroleum marketers and resellers covered by the Petroleum Marketing Practices Act ("PMPA"). The most common types of franchises falling under this exemption are gasoline franchise stations.

- **Large Initial Investments**.
  The FTC Franchise Rule exempts franchise sales where the prospective franchisee makes an initial investment totaling at least $1 million, excluding the cost of unimproved land and any franchisor (or affiliate) financing.
- **Large Franchisees**.
  The FTC Franchise Rule exempts franchise sales to large entities; namely, those that have been in any business for at least five (5) years and have a net worth of at least $5 million.
- **"Insiders" (Officers, Directors, General Partners, Managers and Owners)**.
  The FTC Franchise Rule exempts "insiders" (officers, directors, general partners, managers and owners) of an entity before it becomes a franchisor provided such individuals have been associated with the prospective franchisor within sixty (60) days of the sale and have been involved with the prospective franchisor for at least two (2) years.

Exclusions From The FTC Franchise Rule

In addition to the above exemptions, the FTC Franchise Rule also excludes (a) bona fide employee-employer relationships; (b) general business partnerships; (c) relationships created by, membership in a retailer-owned cooperative association (for example, farmer cooperatives for the sale of farm products); (d) relationships with testing or certification services (for example, electronic products approved by Underwriter's Laboratories and bearing its logo); and (e) "single" trademark licensing relationships.

Additional Prohibitions

- **Contradictory Information**.
  The FTC Franchise Rule prohibits franchise sellers from making any statement that contradicts the information disclosed in the franchisor's disclosure document. Prohibited contradictory statements include those made orally, visually, or in writing.
- **Use of "Shill" Testimonials**.
  The FTC Franchise Rule prohibits franchise sellers from using fictitious references or "shills" misrepresenting that any person has purchased or operated one of the franchisor's franchises, when that is not the case, or that any person can give an independent and reliable report about the experience of any current or former franchisee, when that is not the case.
- **Requested Early Disclosures**.
  The FTC Franchise Rule prohibits franchise sellers from failing to furnish disclosure documents to a "prospective franchisee" earlier than fourteen (14) days in advance of execution of a binding agreement or the making of a payment, if requested,
- **Updated Disclosures**.
  The FTC Franchise Rule prohibits franchise sellers from failing to furnish, upon reasonable request, any updated disclosures prepared under the FTC Franchise Rule's general updating requirements to a prospective franchisee who has previously received a basic franchise disclosure document.
- **Unilateral Modifications**.
  The FTC Franchise Rule prohibits franchise sellers from presenting a franchise agreement for signing that has terms and conditions materially different from those in the copy of the agreement attached to the disclosure document, unless the franchise seller has informed the prospective franchisee of the differences at least seven (7) calendar days before execution of the franchise agreement.

- **Disclaimers and Waivers**.
  The FTC Franchise Rule prohibits franchise sellers from disclaiming or requiring a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or its amendments.
- **Promised Refunds**.
  The FTC Franchise Rule prohibits franchise sellers from failing to make refunds as promised in the disclosure document or in a franchise or other agreement.

FRANCHISE DISCLOSURE DOCUMENTS

In addition to the disclosure document, the franchisor also must furnish a copy of the proposed franchise agreement and any other agreements to be signed by the prospective franchisee. The FTC Franchise Rule deals only with full disclosure and does not regulate any terms of the franchise relationship. No filing or registration of the disclosure document need be made with the Federal Trade Commission.

The FTC Franchise Rule applies in all 50 states and U.S. territories and is intended as a minimum level of protection for prospective purchasers. If the protection afforded under state law is greater in states that have adopted similar specific franchise regulations, the FTC Franchise Rule defers to state law. However, where any portion of the state law provides less protection to a purchaser, the corresponding portion of the FTC Franchise Rule will apply. For instance, the FTC Franchise Rule supersedes less stringent state requirements with respect to the "cooling-off" periods following delivery of a disclosure document (before a purchaser may sign any documents or pay any money to the franchisor). Many states that have adopted franchise regulations require the disclosure format, which will be discussed later. In such states, the FTC Franchise Rule disclosure format may not be accepted for registration.

The information contained in the disclosure document must be updated (i) annually (within 120 days of the close of the fiscal year); (ii) quarterly (within a reasonable time after the close of each quarter); and (iii) in the event of any material changes in financial performance information. Failure to comply with the FTC Franchise Rule may result in an FTC action for injunction, a cease and desist order, monetary damages and civil penalties of up to $11,000 per violation. There is no federal private right of action available to an individual for a violation of the FTC Franchise Rule. However, the FTC may require a franchisor to repay money to the purchaser of a franchise that was sold in violation of the FTC Franchise Rule. Further, several state courts have taken the view that violations of the FTC Franchise Rule constitute violations of the states' consumer protection laws (also known as "little FTC Acts").

FEDERAL REGULATION OF BUSINESS OPPORTUNITIES

On December 8, 2011, the FTC adopted the final amendments to its Trade Regulation Rule entitled "Disclosure Requirements and Prohibitions Concerning Business Opportunities" (the "FTC Business Opportunity Rule") and the final rule went into effect on March 1, 2012. However, prior to the adoption of the FTC Business Opportunity Rule, the offer and sale of "business opportunities." was regulated under the Original Franchise Rule. The Original FTC Rule was intended to correct abusive practices in business arrangements in which the purchaser sells goods supplied by the seller through outlets obtained by the seller.

STATE REGULATION OF FRANCHISE OFFERS AND SALES

The state of California adopted the first state franchise statute in 1971. Since 1971, 15 states (including

California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin) have enacted laws regulating the offer and sale of franchises. With the exception of Michigan and Oregon, these states require the franchisor to register the franchise offering with a designated state agency prior to the offer and sale of franchises. Oregon requires only a full disclosure of all of relevant information relating to the franchise to the prospective franchisee in advance of purchase. The State of Michigan requires disclosure complying with its statute, as well as the filing of a notice of the franchisor's intent to offer and sell franchises in the state. In most instances, the registration process involves administrative review of the required disclosure materials. If the examiner is satisfied that (1) the required disclosure format has been used (i.e., that all required categories of information have been covered and all questions answered; the examiner makes no determination regarding the inclusion of all relevant information or the accuracy of the information contained in the disclosure materials) and (2) that the franchisor has sufficient financial capacity to offer franchises in the state (or is willing to escrow or defer collection of initial fees and other payments due from the franchisee until the franchisee's business is in operation), the franchisor will usually secure registration in that state to offer and sell franchises. Occasionally, a state administrative agency will deny registration due to the precarious financial condition of the franchisor or the background of its principal managers.

On January 23, 2007, the FTC adopted a final amended Franchise Rule ("Amended FTC Franchise Rule"). As of July 1, 2008, all franchisors must prepare and distribute disclosure documents that, at a minimum, comply with the disclosure format of the Amended FTC Franchise Rule. Under the Amended FTC Franchise Rule, states may impose additional requirements under state law consistent with the Amended FTC Franchise Rule.

Prior to July 1, 2008, the disclosure statement that a franchisor prepared for filing in the states that had laws regulating the offer and sale of franchises was called the Uniform Franchise Offering Circular ("UFOC"). The UFOC was generally prepared by a franchisor in accordance with the Guidelines for Preparation of a Uniform Franchise Offering Circular (known as the "UFOC format"), promulgated by the North American Securities Administrators Association ("NASAA") on April 25, 1993.

Although, the Amended FTC Franchise Rule harmonizes the federal and more rigorous state disclosure requirements, the requirements are not identical. In response to the Amended FTC Franchise Rule, NASAA released its 2007 Interim Disclosure Guidelines ("2007 Interim Guidelines"), which streamlined and modified the disclosure requirements in the old UFOC format. The 2007 Interim Guidelines also included detailed instructions for a Uniform Franchise Disclosure Document ("UFDD").

In 2008, NASAA released its 2008 Franchise Registration and Disclosure Guidelines ("2008 Disclosure Guidelines") to assist franchisors in the preparation of the required disclosures for states requiring pre-sale disclosure and/or registration. The 2008 Disclosure Guidelines also dictated that as of July 1, 2008, all franchisors would be required to prepare and distribute disclosure documents that, at a minimum, conformed with the disclosure format of the Amended FTC Franchise Rule. Under the Amended FTC Franchise Rule, states may also impose additional requirements under state law consistent with the Amended FTC Franchise Rule.

In 2008, the UFOC was replaced with a revised format called the Franchise Disclosure Document ("FDD") rendering the UFOC obsolete. Although the current FDD includes most of the rules found in the old UFOC, there were material changes included in the newer FDD format.

Registration does not indicate that the disclosure document has been approved by the state or that the disclosure document has been prepared in compliance with the relevant guidelines. Further, registration does not act as a bar to a franchisee or the state later bringing an action against a franchisor based on information contained in or omitted from its disclosure document.

Like the FTC Franchise Rule, each state franchise disclosure law defines a "franchise." Although the state law definitions are not uniform, for state law purposes, a franchise generally will be deemed to exist when a business relationship contains all of the following elements:

- a contract or agreement, which can be express or implied or oral or written (note that an oral franchise relationship, even though exempt from the FTC Franchise Rule, may still be regulated by state law); between two or more persons;
- by which a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed or suggested in substantial part by the franchisor (a few states substitute the concept of a community of interest in the marketing of goods and services for the marketing plan element of the definition);
- which a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed or suggested in substantial the operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or by part by the franchisor (a few states substitute the concept of a community of interest in the marketing of goods and services for the marketing plan element of the definition);
- the operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and
- the person granted the right to engage in such business is required to pay something of value (e.g., cash, notes or property) in order to establish the relationship, which would constitute a franchise fee.

Caution must be exercised in concluding that a particular commercial relationship is not considered a "franchise" merely because it is not called a franchise or does not require payment of a formal franchise fee. Any money paid to a seller of a business relationship will be considered a franchise fee unless it can be proven otherwise. As previously mentioned under the discussion of the FTC Franchise Rule, a pure distributorship arrangement, where the distributor buys only a commercially reasonable quantity of inventory of tangible goods at bona fide wholesale prices, will not be considered a franchise relationship under most state statutes or the FTC Franchise Rule.

Each of the state franchise registration statutes has a provision exempting certain types of franchises from some or all of its requirements. These exemptions usually apply only to the registration and disclosure requirements of the statutes.

As a result, an exempt franchisor may still be subject to the disclosure, antifraud and unfair or prohibited practices provisions of the state law. A franchisor may meet the criteria for a state exemption, but not be eligible for an exemption from the FTC Franchise Rule. Nevertheless, exemptions from registration/disclosure statutes may free the franchisor from the expense and delay of review by a state administrator. On September 9, 2012, NASAA adopted the NASAA Model Franchise Exemptions ("NASAA Model Franchise Exemptions"), which provided for the following franchise exemptions: (i) fractional franchises exemption; (ii) experienced franchise exemption; (iii) sophisticated purchaser exemptions; and (iv) discretionary exemptions. Depending upon the type of exemption being relied upon by a franchisor, the franchisor may be required to file a Notice of Exemption with the state administrator.

Although these exemptions are common to many of the registration states, each state statute is unique and must be examined carefully before relying on an exemption provision. Furthermore, several states have specific procedures that must be followed to obtain certain exemptions, as well as procedures for the revocation of exemptions. For example, the franchisor may have to file a disclosure document or other documents for the state's review to obtain an exemption. Further, an exemption under a state law does not extend to the FTC Franchise Rule, unless the relationship is also exempt under the FTC Franchise Rule on the same or a different basis.

As is the case under the FTC Franchise Rule, a franchisor must update its disclosure document to reflect any material changes in the information contained in the disclosure document or the occurrence of events that need to be disclosed to prospective franchise buyers, including changes relating to the financial condition of the franchisor, fees paid by the franchisee, litigation of the franchisor and others. The regulatory states require that any material change in the franchised program or the franchisor's financial condition be reflected in the disclosure document within a "reasonable time" after such material change occurs and that the changes to the disclosure document be filed with the state. Some states will require suspension of sales activity during the time in which an amendment to the disclosure document is being processed by the administrator.

Failure to comply with state franchise disclosure regulation may result in a variety of adverse consequences, including not only civil suits by injured private purchasers of a franchise, but also civil fines and criminal prosecution. These penalties may be imposed on officers, directors, employees, salespersons and franchise sales brokers who participated in an illegal sale.

State Regulation of the Franchise Relationship

In addition to the regulation of the offer and sale of franchises, another body of state franchise regulation has emerged in recent years in reaction to franchisee claims of unfair or discriminatory treatment. Legislation has been adopted by about 20 states dealing with such aspects of the franchise relationship as (1) establishing good cause grounds and prior written notice procedures for termination and nonrenewal of franchises; (2) limiting the right of a franchisor to restrict transfers of franchises; (3) prohibiting discrimination among franchisees in charges for fees and in the sale of goods and service; (4) protecting franchisees from the placement of additional franchisor or franchisee owned outlets in a franchisee's market that diminishes the franchisee's revenue and profit; and (5) limiting the right of a franchisor to restrict the sources of supply from which a franchisee buys the operating assets, goods and supplies required for the development and operation of its business. These statutes specifically override the express contractual language of the franchise agreement and impose their own standards upon the franchise relationship. Among the most notorious of these laws is the Iowa Franchise Relationship Act, enacted in 1992 and substantially amended in 1995, and the much older Wisconsin Fair Dealership Act, which has generated hundreds of lawsuits.

STATE REGULATION OF BUSINESS OPPORTUNITIES

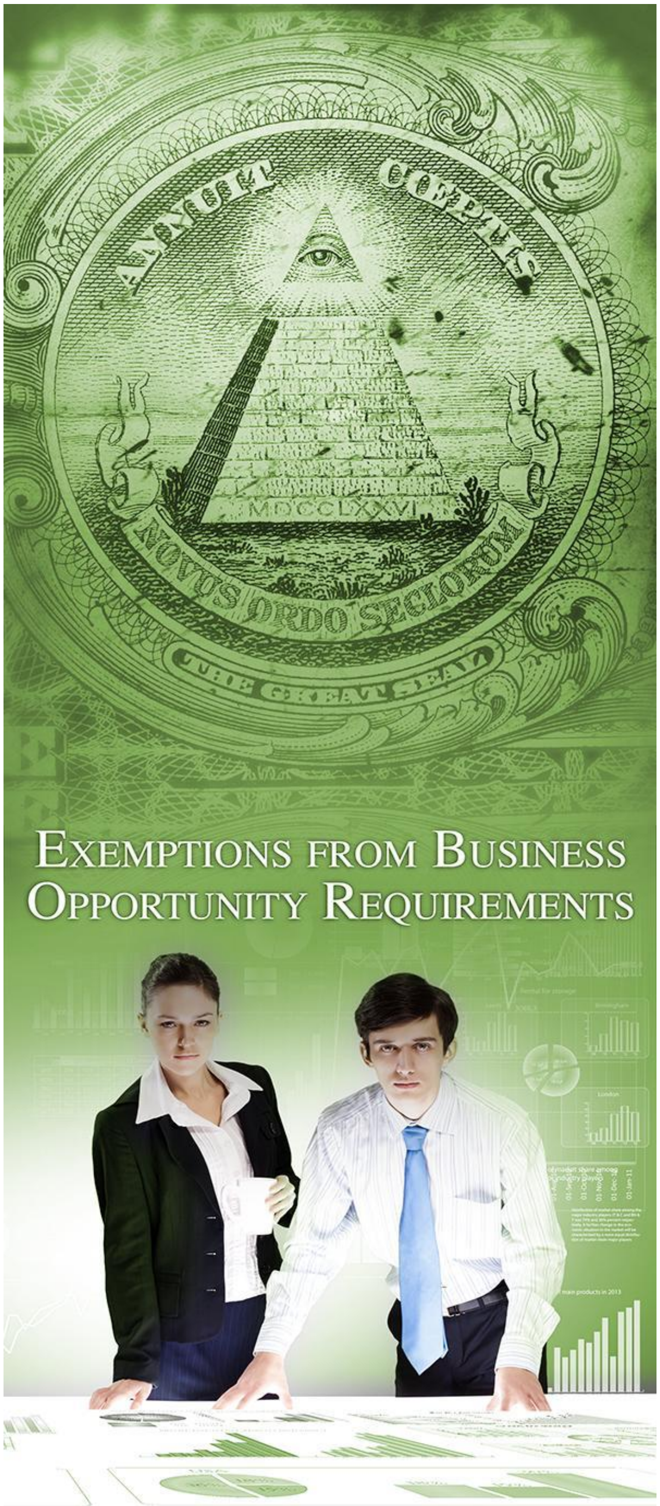
Twenty-six states (including Alaska, California, Connecticut, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia, Washington and Wisconsin) have adopted business opportunity laws that regulate the offer and sale of certain commercial relationships. While these laws were initially intended to regulate particular types of distribution arrangements, the lack of clarity and uniformity in the definitions of a "business opportunity" has resulted in coverage of franchise offerings as well.

The vast majority of the state business opportunity laws require disclosures similar to those required by the FTC Biz Op Disclosure Document ("FTC Biz Op Disclosure Document") adopted by the FTC on March 1, 2012. However, most of these laws require only payment of a fee and filing with the state administrator, who typically gives little or no review to the filed disclosure document. State business opportunity laws also may impose specific bonding or other financial responsibility requirements, irrespective of the franchisor's financial condition. Some of the administrators of state business opportunity laws issue an advertising number, which the business opportunity seller must place on all advertising within the state as proof of registration.

Due to the varied purposes of these state laws, the definitions of business opportunity relationships also vary widely. However, the most common definition of a business opportunity is the sale or lease of any product, equipment, supplies or services to a purchaser upon an initial payment of more than $500 for the purpose of enabling the purchaser to start a business, and in which the seller makes one or more of the following representations:

- the seller will provide or assist the purchaser in finding locations for the use or operation of vending machines, racks, display cases or other similar devices or currency-operated amusement machines or devices on premises neither owned nor leased by the purchaser or seller;
- the seller will purchase any or all products made, produced, fabricated, grown, bred or modified by the purchaser using in whole or in part the supplies, services or chattels sold to the purchaser;
- the seller guarantees that the purchaser will derive income from the business opportunity or that the seller will refund all or part of the price paid for the business opportunity or any of the products, equipment, supplies or chattels supplied by the seller if the purchaser is unsatisfied with the business opportunity; or
- upon payment by the purchaser of a fee or sum of money to the seller, the seller will provide a sales or marketing program that will enable the purchaser to derive income in excess of the price paid for the marketing plan.

The third and fourth paragraphs of the definition are of greatest concern to franchisors, particularly those who make earnings claims to franchisees. If earnings claims are made, this may constitute a "guarantee" for purposes of the business opportunity laws. Even if no earnings claims are made, the franchisor still risks classification as a business opportunity. In any franchise sale, the franchisor makes, at a minimum, an implied representation that the franchisee will derive income. The entire franchise package that is presented to a prospective franchisee often implies that the franchisee will derive profit in excess of his initial fee, and therefore may amount to a representation that the marketing program will enable the purchaser to derive income exceeding the price paid. There does not appear to be any judicial interpretation of these elements of the business opportunity definition. Consequently, it is imperative that companies operating in business opportunity states carefully review their programs with counsel to determine whether compliance is required.



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Exemptions from Business Opportunity Requirements

Business opportunity laws also exempt certain types of distribution arrangements. Among typical business formats exempted under the business opportunity laws are:

- a sales or marketing program sold in connection with a federally registered trademark or service mark.
- a sales or marketing program sold in connection with the licensing of a "registered trademark." Franchise law experts are divided as to whether state trademark registration of the franchisor's mark, in the absence of a federal trademark registration, will qualify for this exemption. Several business opportunity states have adopted the informal position that a "registered trademark" requires a federal registration. The franchisor should carefully investigate this issue before relying on this exemption.
- business relationships that are subject to the FTC Franchise Rule. The franchisor that complies with the FTC Franchise Rule may be exempt from the requirements of a state business opportunity law.

Other exemptions may exist for specific industries, experienced sellers or buyers, sales of ongoing businesses, renewals or extensions, employer /employee relationships and general business partnerships. Under the business opportunity statutes of Texas, Kentucky and Nebraska, franchisors satisfying the states' exemptions must file a one-time notice of exemption (along with the appropriate fee) before franchises can be sold in these states. In the states of Florida and Utah, annual exemption notices must be filed to maintain the states' exemptions.

What Is An Offer?

When a franchisor in a state without franchise or business opportunity laws deals with a state that also has no such laws, only the requirements of the FTC Franchise Rule with respect to delivery of a disclosure document to the prospective purchaser apply. However, when dealing with state franchise and business opportunity registration laws, the critical principle to remember is that the state law must be complied with prior to any offer or sale of a franchise or a business opportunity in the state. In addition, should the franchisor be located within a state with a franchise registration/disclosure law, the franchisor generally will be required to secure effective registration in its home state before offering, or selling franchises anywhere. As a result, it is important to understand what type of franchisor sales activity constitutes an "offer."

Although most state statutes contain a definition of an "offer," they generally are unclear as to what pre-sale conduct by the franchisor does and does not constitute an offer. Typically, an offer is defined as "every attempt to offer, dispose of, or solicit an offer to buy a franchise." Because state regulations construe this definition broadly, almost any contact with a prospective franchisee could be characterized as an offer. In some states, simply mailing a brochure describing a franchise network to a prospective franchisee in another state may constitute an offer of a franchise.

Certain discussions may be conducted between the franchisor and a potential franchisee without triggering state registration/disclosure laws. It is theoretically possible for the franchisor and prospective franchisee to discuss the franchise network generally without the franchisor being deemed to have made an offer, but it is imperative that no terms of the actual sale be referred to during the discussions. As a practical matter, such contacts are not advisable. A state may take the view that the franchisor's communications were specific enough to be considered an offer, and the penalties for making an offer of an unregistered franchise can be severe. Any mention of initial fees, royalties, potential earnings or costs associated with the start-up of the franchise will bring the discussion within the meaning of an "offer." If the franchisor engages in such discussions with a franchisee who is protected by a state registration law and the franchisor is not validly registered, its conduct could be illegal.

Several statutes exclude certain activities from the definition of an offer. For example, most states provide that an offer made through advertising during a television or radio program originating out of state is not an offer for purposes of the statute. Additionally, an exemption exists in most states for the advertisement of a franchise in a newspaper circulated within the state, provided that two-thirds of the newspaper's circulation occurred outside of the state during the last 12-month period. The franchisor should be aware, however, that, absent a prior registration or exemption, placing advertising for the sale of franchises in a state requiring registration of franchise offers will constitute an illegal offer.

Most franchise registration states require that all advertising and promotional materials that offer franchises for sale be submitted to the state administrator for review seven (7) days prior to first publication or use in the state. State statutes generally define "advertising" expansively to include any communication used in connection with the offer and sale of a franchise, which would include recorded telephone messages, form letters, and TV and radio scripts as well as audiovisual presentations. Moreover, some states exclude from the registration of advertising materials “tombstone” ads placed by a franchisor, which are ads containing no more than skeletal information about the franchisor, the franchise and the total dollar investment required. In addition, website content is generally exempt from advertisement filing requirements if (i) the franchisor discloses it URL address on its disclosure document’s cover page in any franchise registration application; and (ii) does not direct the website content to any specific person (e.g., such as through e-mail).

Under the FTC Franchise Rule, franchisors may furnish disclosure documents to prospective franchisees in any fashion they elect, including hand delivery, email, granting access over the internet, fax or, by mailing to the prospective franchisee the FDD in either paper or tangible electronic form (such as on a computer disk or CD-ROM) by first class U.S. mail at least three (3) days before the required disclosure date.

One of the most revolutionary aspects of the 2007 revisions to the FTC Franchise Rule, which captures not only recent technological innovations but seeks to anticipate and capture as well developments which surely will follow, is its authorization for franchisors to engage in “pure” electronic disclosure, subject to certain limitations. First, before effectuating disclosure, franchisors are required to advise prospective franchisees of the formats in which the disclosure document is available so that those prospects may request delivery by a method they can easily use. And second, although franchisors are permitted to utilize navigational tools (such as scroll bars, internal links and search features) in the disclosure document, franchisors are prohibited from using any electronic enhancements -- such as audio, video, other multimedia, pop-up screens and external links -- which a franchisor could otherwise utilize to call attention to favorable portions of its disclosure document and/or distract prospective franchisees from less than favorable disclosures.

Notwithstanding the obvious benefits of pure electronic disclosure for franchisors (e.g. reduction in costs, efficiency, and reliable records), the process would be impossible if, as in the past, a franchisor had to obtain a manually signed disclosure document receipt from each prospective franchisee. Accordingly, the FTC Franchise Rule now expressly permits a franchisee to sign the receipt either manually or by using security codes, passwords, electronic signatures, or similar devices to authenticate his or her identity.” The FTC Franchise Rule also authorizes franchisors to include instructions in their franchise disclosure document receipts regarding how the receipts should be returned to the franchisor (for example, by mail to a specified street address, internet transmission, email, or fax to a specified fax line number).

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Thus, the FTC Franchise Rule permits disclosure document receipts to be executed electronically, but clearly puts franchisors in the position of always having in place a protocol designed to capture proof of such electronic receipts not only for FTC Franchise Rule compliance but also in defense of any litigation claim that disclosure was not properly effected.

To assure that its conduct complies with state law, the franchisor should do the following prior to advertising for, or engaging in, any substantive discussions about the franchise with a prospective franchisee:

- If the franchisor is headquartered in a state that has enacted a franchise registration or business opportunity law that applies to the franchisor's program, the franchisor must register the franchise in its home state.
- For each prospective franchisee, the franchisor must determine the franchisee's state of residence, the state in which the offer of the franchise will be made, where the offer will be accepted, and where the franchised business will be conducted. If any of these states have registration laws with which the franchisor has not complied, the franchisor should consult legal counsel as to the application of such laws. If the laws apply, registration in those states must precede any sales activities.

A franchisor planning to offer and sell franchises in a registration state is required to file with the state its proposed disclosure document, certain application materials and a fee. Initial application fees currently range from $125 to $750. Also, the franchisor will usually be required to make certain changes or additional disclosures in its disclosure document to comply with non-uniform requirements of that state. As a general rule, these changes relate to notice of default prior to termination, good cause for termination, the enforceability of post-termination covenants and jurisdiction and venue provisions. Only in rare circumstances will the state administrator object on the ground of fairness to particular terms of the franchise agreement and require modification of the agreement. However, several states take the position that they have the power to do so if the state administrator finds some aspect of the franchise particularly unfair or prejudicial to the franchisee.

The degree to which administrators review the adequacy of franchise disclosure documents varies widely from state to state, and even within a state, depending on the particular franchise examiner. Factors that affect the review process include the length of time the franchisor has offered and sold franchises, whether the state knows of any prior franchise law violations by the franchisor, whether the disclosure document has been prepared by legal counsel known to the state administrator's staff and the franchisor's general reputation. Most initial franchise registrations receive at least one comment letter from the state, generally including requests for changes to the disclosure document, questions, requests for disclosure of additional information and other concerns of the administrator. After all of the administrator's concerns and requests have been satisfied through compliance or negotiation, the administrator will grant effective registration. This procedure usually takes from two to six weeks, but could take as long as six months, depending upon the quality of the disclosure document initially submitted to the state and the workload of the administrator's office.

State registration requirements delay a franchisor's expansion plans, and cause the franchisor to incur legal costs and filing expenses. Changes required by individual states may result in several different forms of disclosure document, some of which may conflict. As a result, considerable time and expense may be involved in maintaining state registrations and state specific disclosure documents.

From a legal perspective, however, registration with the states can result in benefits. The franchise administrator generally is also the state enforcement officer, and an administrator's resolution of various issues relating to the franchise offering can give the franchisor some degree of comfort that the disclosure document complies with state law. The administrator's interpretation also may be binding upon the state in any subsequent enforcement proceeding. Unfortunately, opinions or interpretations of state administrators may not be binding upon private parties suing under state franchise laws.

The disclosure requirements of the FTC Franchise Rule and various state laws also impose certain burdens upon the franchisor relating to its financial condition. These burdens take two forms. First, the disclosure document requires disclosure of the franchisor's financial statements, the preparation and/or auditing of which may be costly and time-consuming. Second, most state franchise law administrators will review a franchisor's financial condition prior to allowing the franchisor to offer or sell franchises and may require, as a condition of registration of the franchise offer, the escrow or deferral of collection of initial fees and other payments by the franchisee until the franchisee's business is in operation.

FINANCIAL STATEMENT REQUIREMENTS

The disclosure document must include the franchisor's audited financial statements for three previous years in which the franchisor has been in business (the audit may be qualified). The FTC Franchise Rule, however, prescribes a procedure under which the franchisor may commence sales with audits being phased in over a three-year period. The UFOC format requires audited balance sheets for a period of two years and a statement of operations, stockholder's equity and cash flows for a three year period. The UFOC format allows for a waiver of this requirement, in the discretion of each state administrator, only if the franchisor has never previously had an audit. If the franchisor does not have audited financial statements, it may substitute the audited financial statements of its parent company if the parent company guarantees the franchisor's performance under the franchise agreement.

If the franchisor is new and has no parent company willing to guarantee its obligations, it may establish a subsidiary (or its parent company could establish another subsidiary) that would prepare an audited opening balance sheet, or audited statements for the period it has been in business. If neither the franchisor nor the guaranteeing parent company has audited financial statements, the franchisor or its parent company will have to incur the expense of having its financial statements audited for the prior three years or forego franchising in the registration states that do not accept the FTC format offering circular.

AMENDING REGISTRATIONS AND DISCLOSURE DOCUMENTS

To ensure that the disclosure document contains accurate and timely information for the franchisee, the FTC Franchise Rule requires that it be revised within 120 days after the end of the Franchisor's fiscal year and updated on a quarterly basis within a reasonable time after the close of each quarter to reflect any "material changes." Although the FTC Franchise Rule requires only quarterly updates, the franchisor may elect to do so more frequently. This may become necessary where accurate oral representations are being made that may be contrary to outdated information contained in the disclosure document.

The FTC Franchise Rule's annual and quarterly updating requirement does not apply if the franchisor complies with the FTC Franchise Rule by using a FDD format that is registered in any state. In such case, the FTC Franchise Rule's updating requirements will be satisfied if the FDD UFOC format is renewed or amended in accordance with state law in the states in which the franchisor is registered.

Renewal under state law ordinarily is required on an annual basis. A few states require, instead of renewal, that an annual report be made within 120 days of the franchisor's fiscal year end. Each renewal or annual report requires the preparation of an updated disclosure document and current financial statements. This newly submitted data is subject to the same review by the regulatory states as the initial disclosure document filing and registration.

Failure to initiate the process of renewal in a timely fashion may result in a gap between the date of expiration of the existing registration and the effective date of the succeeding registration. During this interim period, the franchisor cannot offer or sell franchises within the regulatory state without violating its laws. Therefore, it is necessary to maintain a log and a tickler system for initiating renewals and annual reports in a timely manner.

Amendments under state registration laws must be made within a "reasonable time" after the occurrence of a material change. A franchisor must, therefore, amend its disclosure document and registrations in the event of a material change in the information contained in the disclosure document, or the occurrence of an event that requires the addition of information to the disclosure document. A reasonable time is generally thought to be within 30 days after the material change occurs.

Disclosure Regulation Compliance Programs

A franchisor must develop and implement an effective disclosure regulation compliance program to protect itself and its franchise network. An effective compliance program will help a franchisor to avoid disclosure law violations and related "costs." These costs include payment of damages and rescission of franchises sold to franchisees who assert violations of disclosure document delivery requirements, attorneys fees' paid to defend the franchisor, payment of the franchisee's attorney's fees, civil fines and possibly criminal liability. In addition, there are many intangible costs of litigation including the time spent by the franchisor's employees and disruption to the franchisor's organization.

An effective compliance program provides the mechanism by which the franchisor can maintain evidence of compliance. Extensive documentary evidence may be critical in defending claims of franchise sales regulation violations. Franchisors cannot take the chance of relying on verbal testimony of employees, especially years after the occurrence. As time passes memories fade, or at the time of trial a key employee may be unavailable or unfriendly to the franchisor. Furthermore, verbal testimony of the franchisor may be insufficient to overcome jury sympathy for the franchisee, especially where the franchisee has documentation that supports a claim. Records established in the ordinary course of business are essential to bolster employee testimony.

How does a franchisor establish an effective compliance program? The first element in developing a compliance program is determining the assignment of responsibility for compliance. Smaller franchisors tend to lodge this responsibility with outside counsel. Outside counsel should be selected carefully to insure that attorneys have compliance expertise and that the law firm has multiple attorneys that can handle questions and problems in the event of the absence of the primary attorney. Franchisors sometimes fail to establish an effective liaison between outside counsel and company personnel with responsibility for keeping disclosure information current and communicating with sales personnel. To do effective work, outside counsel must have a source of timely, complete and reliable information from the franchisor and a responsible manager to whom counsel can communicate compliance status and procedures.

Some franchisors attempt to implement a compliance program by assigning responsibility exclusively to a paralegal or a person without legal training. This approach contains a high risk of error, because effective compliance frequently involves legal analysis and factual evaluation that may be beyond the competence of paralegals and persons without legal training. In addition, such persons often do not have the internal "clout" to get things done or insist upon full compliance.

Franchisors with small legal departments may divide responsibility for disclosure compliance between their legal department and outside counsel. This is a problem only if the responsibilities are not clearly parceled out. Therefore, it is essential to establish a smooth working relationship between the legal department and outside counsel. Franchisors with larger legal departments typically delegate compliance responsibility exclusively to their legal departments. Both types of delegation can work effectively, provided that assignments are clear, the legal department has sufficient resources and exercises independent judgment, the opinions of the legal department are respected by management and disclosure regulation compliance has equal priority with other legal services performed by the legal department.

Whether compliance is delegated to outside counsel, the legal department, or both, it is important to delegate executive responsibility to a compliance officer whose perspective is broader than simply selling franchises. Sales personnel can view lawyers as interposing rules of sales conduct which are designed to inhibit sales. Sales personnel are less likely to be uncooperative with a senior executive. The lawyers and paralegals assigned to disclosure compliance must have extensive knowledge of disclosure regulation and the sources of essential information within the franchisor. In addition, there must be regular communication among the compliance officer, sales department and the legal department and/or outside counsel.

A second element found in an effective disclosure compliance program is the establishment of systems and operating procedures. Systems and operating procedures should be designed to effectively and timely implement registrations; renewals of registrations; amendments to registrations and disclosure documents; sales personnel training; disclosure document and document delivery; recording information relating to offers and sales of franchises; storage and retrieval of disclosure documents, receipts for disclosure documents, franchise and other agreements and sales information; and documenting franchisee defaults. Systems and procedures must be designed to create and preserve evidence that will enable the franchisor's personnel to demonstrate compliance. It is not sufficient to comply with the disclosure laws -- it is also necessary to be able to prove compliance. Information must be gathered in a central place (i.e., the franchisor's home office). All regional personnel should be instructed to transmit specified information to this location. Potential problems are obvious when files are incomplete or poorly organized. When we perform compliance audits, we frequently find document and information storage and retrieval systems that are materially deficient.

There are no clearly delineated rules to guide a franchisor to always accomplish full disclosure. However, if franchisors are guided by the general standard of materiality, they will be right (and relatively safe) must of the time. That general standard is that a franchisor must disclose all information which could have a significant influence on the investment decision of a reasonable prospective franchise buyer. Under the standard, franchisors must disclose some warts and blemishes and these disclosure may result in lost sales. The alternative is significant legal exposure. It is better to lose a sale rather than have an infirm relationship with a franchisee because the sale of the franchise did not comply with the applicable law. If a franchisee becomes unhappy with his decision to buy a franchise, he may claim that the failure to

disclose “material” information induced the purchase of the franchise when in reality it had no impact on the franchisee’s decision to purchase the franchise.

Most franchisors do not include historical or projected sales or profits of franchised businesses (“earnings claims”) in their disclosure documents due to the concern that they will be unable to satisfy the burden of substantiation. Many franchisors candidly admit that it is difficult, if not impossible, to close a franchise sale without responding to questions from the prospective franchisee regarding sales and profits. Directing the prospective franchisee to talk to existing franchisees often is not sufficient. Existing franchisees may not be willing to take the time to answer all of a prospect’s questions. Franchisees may consider this information private. Furthermore, start-up franchisors have no franchisees with which prospective franchisees can talk about the franchise program. After one or two years of franchising, most franchisors can make and substantiate some type of earnings claim, even if it is limited to the gross sales of existing franchised and franchisor operated outlets. The omission of earnings claims from the disclosure document can leave this element of franchise sales open to unauthorized statements by salespersons. Therefore even a limited claim, coupled with a statement that it is the only authorized claim, is a check on embellishment by sales personnel and may weaken a franchisee’s claim of reliance upon alleged claims by sales personnel.

A franchisor must also establish a procedure for disposition of inquiries from states in which the franchisor is not registered. The franchisor must determine which state laws are applicable by checking where the franchisee and its partners or shareholders are domiciled and where the franchise is to be located. The franchisor should avoid sending disclosure documents or other materials constituting an offer of a franchise into a state where the franchisor is not registered. It is permissible, however, to describe the franchisor’s intent and status regarding registration and projected date of follow-up contact. However, a franchisor should not send advertisements into a state where the franchisor is not registered. Such conduct constitutes an illegal offer.

A franchisor must also develop procedures for evaluating developments and amending registrations and disclosure documents to reflect material changes. The compliance officer must engage in regular communication with the legal department or outside counsel and focus on such sensitive areas as litigation developments, increases in costs of developing the franchised business and adverse changes in the franchisor’s financial performance or condition. In addition, a system must be established to determine the compliance requirements applicable to franchise transfers. A transfer involving an existing agreement is often an exempt transaction if the franchisor is not significantly involved in the transfer. Approval of the transferee by the franchisor is not considered significant involvement. However, if the franchisor requires the transferee to sign the “then current” form of franchise agreement or “brokers” the transaction, the transaction will not be protected by the exemption for intra-franchisee transfers.

The compliance officer should debrief all prospective franchisees before execution of documents to determine if unauthorized statements or promises were made to them by overzealous salespersons and whether sales personnel are complying with franchisor policies relative to disclosure regulation compliance.

Sales personnel should be carefully interviewed when hired and background checks should be conducted to determine whether they have been involved in criminal or civil cases, bankruptcy proceedings or illegal sales practices in prior employment positions. Salespersons should have an understanding of franchise sales regulation and should display a positive attitude toward compliance with regulation. Systems and procedures should include a disclosure regulation compliance training program for sales personnel. A franchisor should develop checklist type forms for sales personnel to complete during the sales

process and these documents should be created routinely in the ordinary course of business.

When developing advertising materials franchisors should avoid prohibited claims and misleading statements. No advertisement should contain an explicit or implicit statement that the purchase of the franchise is “risk free” or a “safe” investment or state that profits are assured or that losses are unlikely. Advertisements should not create unrealistic expectations by franchisees. A franchisor should avoid communicating unrealistic expectations relative to the efforts and time that the franchisee must put forth to make his business successful. In addition, a franchisor should avoid excessive claims relative to services to be performed by the franchisor or the progress of the franchisor’s network or the franchisor’s capability. These claims may cause the franchisee to distrust the franchisor or be disappointed in the franchise, if it does not meet the franchisee’s unrealistic expectations.

The compliance officer, with the assistance of legal counsel, must also monitor changes in regulation of franchise offers and sales by identifying the sources of change (i.e., statutes, regulations, administrative policies or judicial decisions) and consider the impact of these changes on the franchise sales program. The compliance officer must stay abreast of such changes to insure that the franchisor stays in compliance with franchise sales regulation, which is modified from time to time.

Effectively Documented Relationships

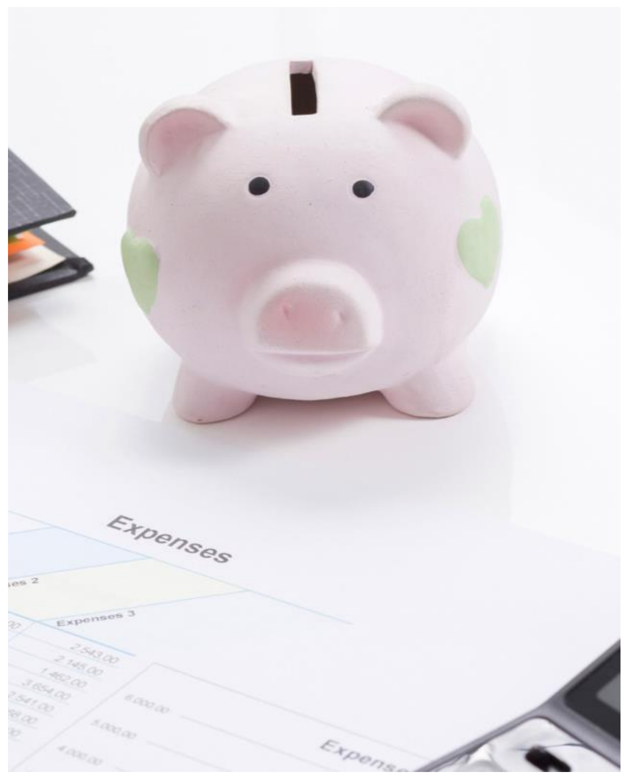
A successful franchisor usually has developed a well-organized, complete and understandable franchise agreement. Though most franchise agreements are written in the traditional third person format (e.g., the parties are referred to as “Franchisor” and “Franchisee”), a growing number of franchise agreements are being drafted in the less formal first person (i.e., the franchisor is referred to as “we” and “us” and the franchisee is referred to as “you”). A first person document is more readable and less intimidating than the traditional third person format. A franchise agreement drafted in the first person is no less a binding and enforceable contract.

In addition to a less formal style of franchise agreement, franchisors should carefully consider other means to simplify their agreements. Good organization and simple, short sentences are both helpful. In addition, including in the agreement only the essential elements of the franchise relationship, and essential legal and procedural matters, contributes to a simple, user friendly document. The operations manual is the proper location for specifications, standards and operating procedures ("system standards") that describe and prescribe the operating and management systems of the franchisor's business. As noted above, the franchise agreement should give the franchisor the right to prescribe and modify system standards, incorporate them by reference into the franchise agreement and provide that a franchisee's failure to comply with one or more system standards, after notice and a reasonable opportunity to cure, is grounds for termination of the franchise agreement.

Most franchisors utilize collateral documents to supplement the franchise agreement. These may include subleases, collateral lease assignments, financing documents, rights of first refusal for additional franchises and software license agreements. The admonition to draft a well-organized and readily understandable franchise agreement applies equally to such collateral documents.

The operations manual should also be "user friendly." It must be well organized and simply written so as to be understandable not only to the franchisee but also to the managers of the franchisee's business. Writing a complete, well organized and readily understandable operations manual is more difficult than it might seem and requires good communications skills. The franchisor is, of course, the best source for the content of its operations manual, but a communications professional is usually the preferred resource for the organization and style of the operations manual.

The third document required in every franchised network is the disclosure document. Virtually all franchisors use the Uniform Franchise Disclosure Document ("UFDD") disclosure format prescribed by the North American Securities Administrators Association, which is discussed above. As of July 1, 2008, the NASAA Franchise Registration and Disclosure Guidelines ("NASAA Disclosure Guidelines") replaced the NASAA Uniform Franchise Offering Circular Guidelines ("NASAA UFOC Guidelines"). The NASAA Disclosure Guideline requires disclosure documents to be written in "plain English," and to avoid legal terminology and the passive voice. Some state franchise law administrators interpret these rules to greatly limit the franchisor's choice of expression to communicate information about the franchisor and the franchise it offers. Compliance is best achieved, and the disclosure document is made a better communications device, if a disclosure document is written in the first person format and utilizes simple and short sentences.



Part V: Elements Of Successful Franchising

Few other business arrangements are so all-encompassing. Unless a franchisor and its franchisee deliver to each other what they have promised, the supply system to the customer will be compromised. World class franchise systems are easily recognized by the mutual commitment of the franchisor and franchisee to their network and the resulting consistently high level of customer approval of their products or services. The more important elements of successful franchise relationships and networks are discussed below.

A Franchise Relationship Must Have An Effective Structure

Franchising is a contractual relationship. The franchisor and the franchisee each make commitments and agree to operate under certain constraints. In the aggregate, these commitments and constraints constitute the structure of a franchise relationship. That structure must protect the franchisor and all franchisees of the franchise network and afford opportunity and security to the franchisee. There are a number of elements of the structure of a franchise relationship that are critical to its effectiveness as the foundation for an expanding franchise network. The most important elements are discussed below:

Control of products and services that franchisees are permitted to sell

Franchisors control the products and services that their franchisees are permitted to sell in order to control the quality of the goods and services sold by franchisees (i.e., by limiting the scope of the franchised business to those products and services that are within the scope of the franchisor's expertise) and to preserve a uniform image (i.e., the means by which a franchisor defines its business). It is common for franchisors to permit some franchisee experimentation and variation because franchisees are an excellent source of innovation, regional variations may be necessary and different customer bases may require variations in product or service mix or different emphasis.

Control of operating assets, goods and services utilized and sold by franchisees

Franchisors control the sources from which their franchisees purchase operating assets (equipment, fixtures, furnishings and signs) and goods and services required to operate the franchised business for one or more of four basic reasons: (a) to control the quality and uniformity of the goods and services sold by the franchisee; (b) to assure sources of high and uniform quality goods at prices that are competitive with or lower than those available from other sources; (c) to protect confidential information; and (d) to be a profit center for franchisor.

These are all legitimate reasons for controlling the sources of supply utilized by franchisees, provided that the restrictions (1) do not cause the costs incurred by franchisees to exceed what such costs would be for comparable products absent such restrictions (ideally, and in many franchise networks, supply restrictions are part of supply programs that lower costs to franchisees), or (2) the extra cost is disclosed to franchisees (and is presumably considered to be part of the consideration paid for the franchise). Franchise disclosure laws do require disclosure of such restrictions and the revenue that the franchisor derives as a result. Antitrust law also regulates such restrictions, but under prevailing interpretations, does not have a significant impact on the types of restrictions that a franchisor may impose. As a general proposition, franchisors should limit source restrictions to those products and services that are important to the development and operation of the franchised business and cannot be simply specified by brand, model and/or grade.

A franchisor also can derive revenue from supply programs. Franchisors evaluate the total revenue produced by a franchised business from (1) royalties and service fees, (2) advertising contributions or fees, (3) sales of goods to the franchisee, (4) commissions paid by other suppliers and (5) rental income from leasing real estate. Most franchisors have more than one source of revenue from each franchised business. Some franchisors rely primarily on fee revenue and other franchisors rely primarily on the sale of goods to their franchisees. For a few franchisors, rent is a significant source of revenue.

The aggregate revenue received from a franchised business must be sufficient to support essential franchisor services that maintain system standards and keep the network competitive, and to produce a profit for the franchisor. The aggregate of the revenue a franchisor derives from a franchised business must allow the franchisee to realize a sufficient rate of return on its investment. Several franchised networks have reduced or eliminated royalties and advertising contributions. Such networks rely on sale of products to their franchisees and the sale of services at the franchisee's option. If franchisees elect not to buy such services, the network's competitiveness could be jeopardized. Such franchised networks also rely on advertising paid for by the franchisor out of gross profit on sales of goods to its franchises and/or local advertising by franchisees, which may be partially supported by the franchisor. This approach can be effective if the franchisor sells to its franchisees a proprietary product or a product that it can sell competitively to them. A franchisor might decide to reduce or eliminate royalty and advertising fees in order to aid struggling franchisees and prevent shrinkage of its product distribution network.

When a franchisor relies primarily on product sales to its franchisees, its revenue base may be less secure and competitors may target its franchised network, but it is less dependent on monitoring its franchisees to insure proper royalty calculation and payment.

CONTROL OF THE FRANCHISEE'S BUSINESS PREMISES

Franchisors sometimes control the franchisee's business premises by leasing or subleasing the premises to the franchisee or requiring the franchisee to sign a collateral assignment to the franchisor of the lease for his business premises. Control of the franchisee's business premises gives the franchisor more effective control of the franchisee and his business. The premises continue to be part of the franchisor's network even if the franchisee does not. However, such control increases the capital requirements of the franchisor or involves contingent liability and administrative effort and cost, unless control is implemented by means of collateral lease assignments. It is generally difficult to secure consent to such assignments from regional malls and it may be difficult to secure consent from any landlord without at least some guaranty by the franchisor of the payment of rent and common area maintenance charges for the leased premises.

Control of the franchisee's business premises also confronts the franchisor with a potentially difficult policy issue when the franchise expires. If the franchise is not renewed, the automatic transfer of the premises to the franchisor may transfer the value of the franchisee's business to the franchisor. Such a franchise would have no residual value and a franchisee that is uncertain regarding renewal will be motivated to milk every dollar he can out of his business in the later years of the term of his franchise, possibly severely damaging the business. One possible solution is a policy that enables a non-renewed franchisee to realize the location Goodwill of his business by selling it to an approved successor

franchisee during the last two or three years of the term of his franchise. The franchisor then grants a new full term franchise to the successor franchisee.

GRANT OF EXCLUSIVE OR PROTECTED TERRITORIES

Franchisors grant exclusive or protected territories to their franchisees to facilitate sales of franchises and to motivate effective market development by the franchisee who, theoretically, will be more inclined to invest in the development of his business if he has no same brand competition in his territory. Franchisors should resist the temptation to grant large exclusive or protected territories because they may weaken the market penetration of its network by leaving large areas unserviced or underserviced by franchises.

Many franchisors have discovered that they made inflated initial estimates of the population base required for a successful franchised business (once their network trademark became more widely recognized) and that large spaces between franchisees only invited competitors. Large territories also may interfere with adjustment to changing markets and inhibit the offering of additional franchises to productive franchisees. A franchisor should consider reserving from their grant of an exclusive or protected territory the right to sell directly to customers that buy for regional or national facilities, to sell in other channels of distribution (e.g., mail order sales, supermarkets and department stores) and acquire, or be acquired by, a competitor with franchised or company-owned outlets in the protected territories of its franchisees.

Structuring the franchise to enable the franchisor to achieve greater market penetration by granting limited territorial protection and reserving rights to sell to some customers within the franchisee's territory will tend to result in more system expansion conflicts with existing franchisees. The franchisor must be sensitive to these conflicts and develop internal procedures to resolve as many as possible. Such procedures may include participation by existing franchisees in expansion decisions and payment of compensation to impacted franchisees.

Control of the Geographic Scope of the Franchisee's Business

The corollary of the exclusive or protected territory, a right granted to the franchisee, is a restriction on the area within which and the customers with whom the franchisee may conduct his business. If franchisees have the ability to sell outside their immediate markets and are able to market and sell in the territories of adjacent franchisees, restrictions on such marketing may be necessary to make exclusive or protected territories meaningful. Franchisors also impose such restrictions to force a franchisee to fully exploit his assigned territory and to maintain the quality of the product or the service sold by the franchisee, (e.g., by restricting the distance that a franchisee may deliver perishable products). Such restrictions frequently include a ban on mail and telephone order sales and sales to dealers for resale (in order to restrict the source of the franchisor's product or service to franchised outlets that comply with format, appearance and service requirements).

Confining franchisees to their specific markets can result in troublesome enforcement problems for the franchisor. The franchisor will be expected to enforce the restriction against the invading franchisee (and may have a legal obligation to do so). The invading franchisee may be highly productive, have effectively penetrated his own market and invade the territory of the adjacent franchisee primarily because that territory has not been effectively penetrated. Disciplining a productive franchisee to aid a lazy or ineffective franchisee is not an enviable task. Some competition among franchisees may be beneficial to the network.

Exclusive Relationship

Franchisors typically prohibit their franchises from having investments in or performing services for a competitive business. This prohibition is intended to protect confidential information, maintain the franchisor's revenue, prevent use by competitors of the franchisor's know-how and focus the franchisee's efforts on his franchised business.

Such prohibitions are sometimes limited to the franchisee's territory or a larger territory, but frequently have no geographic limitation. Prohibited competitive businesses may be defined narrowly (e.g., to include only a business primarily selling the same type of product or service) or broadly, including related types of business (e.g., all fast food service businesses). Such prohibitions typically apply not only to the franchisee but also to its owners and members of their immediate families. Such prohibitions are enforceable under the laws of most states, but not necessarily as broadly as they are sometimes drafted. Many franchisors elect to prohibit both direct and remote competition over a large geographic area, assuming that the prohibition will be partially, if not fully, enforced. Such prohibitions are a deterrent to the franchisee, who risks termination of his franchise if he does not comply.

Transfer of the Franchise

Franchisors restrict transfers of their franchisees in order to maintain control over the persons who operate them. Such restrictions should apply to the franchise agreement, ownership of franchisee and the assets of the franchisee's business. Typically the franchisor reserves the right to approve the transferee and the terms of transfer. The right to approve the terms of transfer is important to insure that the buyer of the franchisee's business does not substantially overpay for it, or accept burdensome payment terms, which could jeopardize his ability to operate the business in compliance with the terms of the franchise. Some franchise agreements merely provide that the franchisor will not unreasonably withhold approval of a transfer. Others specify in considerable detail the criteria for approval relating to the proposed transferee and the terms of the transfer.

It is common for franchisors to reserve a right of first refusal to buy the franchisee's business on the same terms as are offered by a bona fide purchaser. Franchisors exercise this right to acquire franchised businesses as company-owned outlets and, occasionally, in lieu of denying approval of a proposed transfer (e.g., when the franchisor is unsure that it has sufficient grounds to disapprove a prospective transferee).

EXPIRATION

Franchises are granted for a definite term (usually 5 - 20 years), and therefore will expire at the end of such term. Some franchise agreements are silent on the subject of the extension of the relationship upon its expiration or the grant of a successor franchise to the franchisee. Others deal with this significant element of the franchise relationship, providing for the preconditions for the grant of a successor franchise (e.g., compliance during the term of the initial franchise and upgrading the business to meet current standards) and the terms on which it will be granted (e.g., the terms of the franchise agreement used by the franchisor when the franchise expires).

If a franchise is not renewed, the restrictions on the business activities of the franchisee (and its owners and members of their immediate families) are an issue. Some franchise agreements provide for a post-expiration covenant not to compete, which raises the residual value issue discussed above. If the franchisee is prohibited from operating the same type of business in the same market (under a different trademark) subsequent to expiration (even for a relatively short period, such as one-two years) he will lose whatever "going concern" value his business has apart from value of the expired franchise. Such value may consist of location value and the personal goodwill of the franchisee in his market. The franchise will thus have no residual value, which may motivate the franchisee to operate his business for maximum short term gain during the later years of the term of his franchise. As noted above, this problem may be addressed by giving the franchisee the option to sell his business to a successor franchisee during the two or three year period preceding the expiration of the franchise.

Some franchisors reserve an option to buy the franchisee's business upon termination or expiration of the franchise. The purchase price may be determined by a formula or be the fair market value of the business, without any value attributed to the expired franchise (usually determined by appraisal if the franchisor and the franchisee are unable to agree

on fair market value). If the fair market value standard is used, the franchisee realizes the value of his business that exists apart from the franchise and his own personal goodwill (i.e., location value).

Operating and Management Systems, Products and Services That Benefit Franchisees

A franchisor must have effective operating and management systems for use by franchisees in operating their businesses. A franchisor must also furnish valuable services to its franchisees. A franchisor may offer a wide range of valuable services. These include: (1) site selection and outlet development services; (2) effective initial and continuing training (effective training is critical to achieve positive franchisee attitudes regarding system standards, the franchisor and the value of the franchise; inadequate training is a common cause of poor franchisee performance); (3) sensible and complete specifications, standards and operating procedures (system standards) effectively communicated to franchisees (e.g., detailed specifications, standards and procedures for the development and operation of the franchised business and a well-organized and readily understandable (i.e., "user friendly") operations manual); (4) procurement programs for equipment, goods, materials and services; (5) advertising and marketing programs to maximize the advantage of the common trade identity of the network; (6) effective field service (knowledgeable and well trained personnel with positive attitudes and a willingness to help franchisees); (7) research and development (e.g., maintaining current information regarding competitors; development of new products and services; and improvements in equipment, formats, operating efficiency and safety); and (8) development and improvement of services with value to franchisees (e.g., customer referral systems, financing, franchise resale programs, insurance programs-and crime prevention programs).

Management Philosophy and "Culture" Must Be Consistent With the Franchise Relationship

The management philosophy and "culture" of a franchisor is manifest in a variety of attitudes and interfaces between franchisor management personnel and franchise owners. Though the franchise relationship is governed by a contract, a contract cannot anticipate all contingencies or problems. It is essential for a successful franchise relationship that mutual trust and respect develop between franchisor and franchisee, to supplement the contract and enable the franchise network to maintain a competitive position in its market.

Initially, management must develop criteria for identification of high potential franchisees and the patience to select qualified candidates. Management must include good teachers and motivators and must have the commitment and patience to develop and cultivate sound, durable and positive franchise relationships. Such franchise relationships require real two-way and regular communication with franchisees. A franchisee must believe that his opinion is respected and management must be sensitive and responsive to franchisee concerns and problems. Management must have a flexible approach to franchisee problems and a willingness to assist franchisees in solving problems. A franchise network should have impartial internal dispute resolution procedures and genuine efforts should always be made by the franchisor to resolve disputes amicably.

Franchise networks also need systems for obtaining, evaluating and sharing ideas developed by franchisees and the franchisor and should allow franchisees scope for creativity and decision making and permit some degree of innovation by franchisees (who, as noted above, may be the network's best source of ideas and productive innovation). Many franchisors make effective use of a franchisee advisory council or association: (1) to communicate with their franchisees; (2) to resolve individual franchisee, network and competitive problems; (3) for long-term planning; and (4) to give franchisees a sense of participation in the evolution of the franchise and the network. It is perhaps a trite, but nevertheless accurate, observation that a franchisee must believe that he owns his business and that he is in business for himself, but not by himself.

Management must have a commitment to franchisee profitability and equity growth and the creativity to maintain the value of the franchise. A franchisor's management must sometimes be willing to sacrifice short-term profitability of the franchisor to ensure franchisee success. A franchisor and its franchisee each assume a responsibility to support a network of businesses that operate under a common trade identity (the performance of one reflects on all of the others). In the most successful franchise networks, the franchisor and the great majority of the franchisees do not view their responsibility and commitment as limited by their contract. They think of it as being whatever level of effort is required to assure that the network continues to be a leader in its industry.

Expand Its Network at a Manageable Rate

Initially, a franchisor must determine the markets in which the franchised business is most likely to be established successfully. These usually will be markets that meet most of the following criteria: markets in which (1) franchisees can be effectively monitored and supported, (2) in which good sites are available at affordable costs, (3) that are not saturated with competitive businesses, (4) that are not dominated by one or more large competitors, (5) in which suppliers can effectively and economically deliver essential products and materials and (6) in which the network trademark is recognized. It is generally advisable to concentrate expansion in one or a few markets where "critical mass" can be achieved quickly in order that the network have in such markets effective advertising, support and assistance and effective monitoring of franchisee performance. A franchisor's ability to expand is limited by its financial, management, supplier and field service resources. Franchisors who fail to understand the limitations on their ability to effectively expand are more likely to fail in improvidently selected expansion markets.

In mature franchise systems, decisions by the franchisor to establish additional outlets in proximity to existing franchisees is seen by those franchisees as encroachment on their businesses. Franchisees resent and resist such perceived encroachment and the franchisor is confronted with a choice between fully penetrating the market and preempting competition, at the cost of impairing existing relationships, and accepting a lower level of market development.

Encroachment problems also arise when a franchisor attempts to penetrate franchised markets through nontraditional outlets or distribution channels (distribution in department, grocery, convenience or general merchandise stores, on college campuses, on military bases, at interstate highway rest stops, through mobile carts and kiosk facilities and in combination or dual branding arrangements). Achieving the optimal balance between effective market penetration and good franchise relationships is difficult. Even the best managed franchised networks have difficulty resolving the problem of balancing the imperatives of network expansion and competition with perceived interests of existing franchisees.

Develop and Implement Effective Systems to Secure High Quality and Consistent Operations at Franchised Outlets

A franchisor generally has less control over franchised outlets than it would over company-owned outlets. Maintenance of high and relatively uniform standards throughout a network is of significant value to those franchisees who voluntarily maintain system standards and perceive system standards as a valuable element of their franchise. If a franchisor fails to establish and maintain system standards, its competitive position and the value of its franchise will decline. The most productive and successful franchisees may break away and the ability of the franchisor to sell franchises and to expand will be impaired.

The franchise relationship can be inflexible. Franchises may resist changes needed to adapt their businesses to changing markets by upgrading their business facilities, changing the product/service mix, modifying operating procedures, adopting different marketing strategies and modifying the image of the franchised business. If changes involve capital investment or higher operating costs, franchisees may disbelieve that higher sales or profits will result. Franchisees may also resist change due to satisfaction with a low level of market penetration and competitive effort.

It is, therefore, imperative that a franchisor develop the abilities and programs to motivate franchisees to voluntarily comply with system standards and implement the changes that the franchisor determines necessary to adapt to a changing market and meet competitive challenges. The first step in developing such abilities and programs is an understanding of the causes of franchisee noncompliance. These include failure by the franchisor (1) to furnish effective and complete training; (2) to effectively communicate system standards; (3) to inspect and communicate appearance and operational deficiencies to franchisees; (4) to assist franchisees to correct deficiencies; and (5) to observe standards at company-operated outlets. A franchisor must implement policies, systems and procedures that help maintain standards by rewarding compliance (e.g., by recognition and awards and the grant of additional franchises) and enforcing system standards where positive motivation proves to be insufficient. Many franchisors make effective use of peer pressure by other franchisees to achieve compliance with system standards. Inspection reports should be reviewed with franchisees and realistic timetables should be determined and agreed upon for correcting appearance and operating deficiencies. Follow-up inspections should be timely conducted and a franchisor should be prepared to offer assistance to a franchisee who is making a bona fide attempt to bring the appearance and operation of his business into compliance with system standards.

The tension between a franchisor's need to control the appearance and operation of the franchisee's business and the heavily promoted "independence" of the franchisee is not always satisfactorily resolved. Independent business ownership is asserted and promoted as a positive aspect of the franchise relationship, but the requirements of quality control and uniform image impose limits on such independence. If a franchisor fails to secure voluntary compliance from the great majority of its franchisees, it faces potentially difficult and costly enforcement obligations. Longstanding neglect of system standards can result in loss of ability to effectively implement those standards. Noncomplying franchisees may damage the reputation of a franchised network. Termination of franchise relationships can be difficult and expensive. Some state laws give franchisees broad rights against termination and nonrenewal. In some instances, a franchisor may have to buy a noncomplying outlet at a premium over its value to achieve a quick end to substandard appearance and operations.

Maintain Its Value to Franchisees

The benefits and services furnished by a franchisor must have continuing value to franchisees relative to the cost of the franchise. A franchisor faces several obstacles in achieving a general perception among its franchisees that the value of the services furnished by the franchisor is equal to the fees they pay. Fees payable to a franchisor typically increase

with increases in franchisee revenue. The scope and frequency of the services furnished to maturing franchisees may remain level or decrease and franchisees may perceive a declining need for and value of the services furnished by their franchisor.

This problem can be compounded by the tension inherent in a fee based on gross revenues. The franchisor's interest is perceived to be to maximize sales and the franchisee's interest is to maximize profits. Services designed to increase sales may not be perceived by franchisees as likely to increase profits, especially when the sales enhancement program involves a capital investment by the franchisee or higher operating costs.

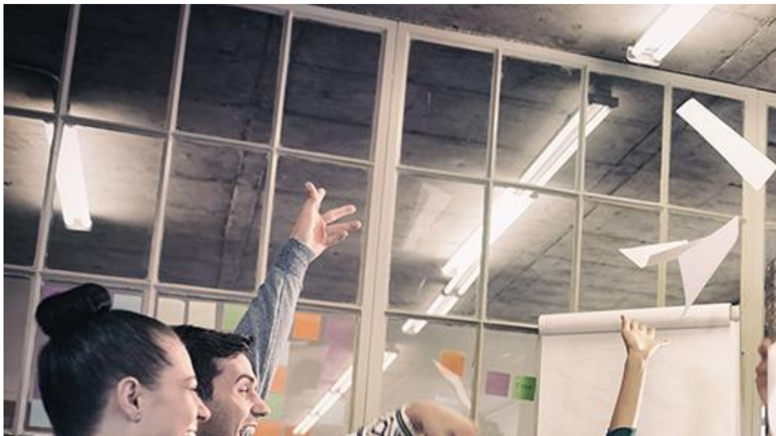
Even a high level of benefits and services will not always overcome disaffection of some franchisees with the franchise network. Over time, some franchisees are likely to lose interest in the franchised business or be satisfied with a low level of market penetration. The profits of a franchised business may be invested in other businesses, leaving the franchised business with insufficient capital, and the attention of a franchisee may be diverted to other business interests. Though no level of service or benefit may entirely prevent such problems, the franchisor that fails to maintain valuable services and benefits will encounter franchisee disaffection, including break-away franchisees, on a greater scale.

A franchise network is at some risk when it loses an effective franchisee. Each franchisee is a potential competitor when the relationship ends. The franchisees know the franchisor's business. It is difficult and expensive to enforce covenants not to compete (such covenants are not universally enforceable and are never enforceable for more than a short period (1-2 years). Confidential information of the franchise network is difficult to protect and vulnerable to disclosure and use by competitors.

Dispute Resolution

The franchise relationship has a high potential for disputes. A franchisor has business relationships with scores, hundreds and, in some networks, thousands of franchisees. The franchisees of a network entered into their relationships with the franchisor at different times and with differing expectations and goals. The franchisor must operate its business for the benefit of its owners and its franchisees and steer its network in what it determines to be the right direction. Some franchisees are likely to disagree with the balance the franchisor chooses between its owners and its franchisees or with the direction that the franchisor charts for the network. Therefore, it is essential that a franchise network develop effective dispute resolution procedures. Such procedures may include any combination of negotiation; an ombudsman; internal dispute resolution procedures involving participation by neutral franchisees and members of the franchisor's management; and third party, non-binding mediation. These are all nonbinding methods used to resolve a dispute without resort to some form of binding dispute resolution (i.e., litigation or binding arbitration). Nonbinding dispute resolution methods are generally effective in resolving disputes, but will not always produce a mutually satisfactory resolution.

A franchisor should consider arbitration as the method of binding dispute resolution instead of relying on litigation. Though arbitration is not without problems and costs, it is, on balance, a faster and less costly method than litigation of resolving a dispute that cannot be otherwise resolved. The accelerated resolution and lower cost of arbitrated disputes results from the elimination of most discovery (e.g., interrogatories and depositions) and various techniques commonly used in litigation to narrow the issues to be resolved.



Cost is further reduced and a final result achieved more quickly because an arbitrator's decision may only be appealed in limited circumstances. The ability of franchisees to join together in a lawsuit, or of one or more franchisees to bring a suit against a franchisor on behalf of a class of current or former franchisees, can probably be precluded by a well drafted arbitration clause, though the law on these issues is not well developed. However, inability to narrow the issues in dispute and to learn by pretrial discovery the other side's theories and factual support, and the limited scope for appeal of an arbitrator's decision, is viewed by some as a significant disadvantage of arbitration. Nevertheless, if a franchised network's formally decided disputes are projected over an extended period, and assuming that the franchisor's management has the good sense to informally resolve disputes in which the franchisee's claims or position is reasonable or the facts do not strongly support the franchisor's claims or position, arbitration is likely to prove an effective dispute resolution method from the perspective of cost and minimizing the strain of disputes on the franchise relationships of the network.

Other elements of dispute resolution that a franchisor should include in its franchise agreement are a waiver by the franchisee of a right to a jury trial and to recovery of punitive damages and a provision for a period within which claims may be asserted substantially shorter than the period provided by statute or common law (to cut off claims that could otherwise be asserted long after they allegedly arose).