BUSINESS ASPECTS OF FRANCHISING

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I. (§68.1) OVERVIEW

Franchising is a business approach that originated in the United States and has spread throughout the world. By recent count, more than 760,000 franchise outlets exist in the United States, with many thousands more in countries around the world. Franchising is the cause of over 13% of the United States' private-sector employment and generates over $1 trillion in annual sales for the United States economy. This remarkable impact is expected to increase: over one-third of all retail sales of goods and services in the United States are made through franchised businesses, and most experts agree that this percentage will increase significantly in the near future.

Franchising has been defined as a business opportunity by which the producer or distributor of a trademarked product or service grants rights to an individual for the local distribution or sale of the product or service, and in return receives a payment or royalty and conformance to quality standards. Three advantages are commonly enjoyed by a franchise system: economies of scale that allow increased advertising and product buying power, trade name goodwill generated by standard operating procedures and market expansion, and harnessing of the entrepreneurial spirit of franchisees.

The seller of a franchise is called the *franchisor*. The buyer is the *franchisee*.

Franchising allows a franchisor quickly to expand proven concepts and

methods of operation with the leverage of its franchisee's investment. *See* §68.12, *infra.* For the franchisee, franchising gives a small business entrepreneur the advantages of proven methods of operation; expert oversight, broadly based, high-impact promotions; popularly recognized trade names; and ongoing business support. *See* §68.14, *infra.* Thus, franchising permits small businesses to compete with large corporations to capture consumer interest and to expand well-developed know-how, quality standards, and trademark goodwill.

On the other hand, franchising is a team concept; mutual cooperation and trust are necessary to develop and maintain a beneficial franchise relationship. The franchisor brings to the team an understanding of the marketplace, the know-how to exploit the systems, services, or products in the marketplace, cooperative purchasing and advertising power, and training expertise. The franchisee brings to the team the financial ability to develop a local business outlet, a knowledge of the local community and its market circumstances, the capacity to focus time and energy into developing the local outlet, and the capacity to carry out standardized operations guidelines. As with any other team, each role is important to achieving success. Potential disadvantages, if the franchisor and a franchisee do not work well as a team, include a franchisee's

overdependence on the franchisor, the franchisor's failure to provide the expertise and services needed by the franchisee, or the franchisee's failure in the system to properly operate or take advantage of market potential. *See* §§68.13, 68.15, *infra.*

Franchising has existed in one form or another for centuries. Notwithstanding this long history, the development of franchise law is relatively recent. The first statute to focus on franchise issues was introduced in California in 1971. *See* Cal Corp Code §§31000–31516 (West 1977). The courts, however, had been treating conduct arising out of franchise relationships long before that time.

A franchise agreement is subject to the general laws of contract. Simply defined, a *contract* is a legally enforceable business understanding between two parties. All principles of law governing contractual relationships and business practices apply to franchises. *See generally* Contract Law in Oregon (Oregon CLE 1991 & Supp 2003).

Other principles of law also apply to the franchise relationship. For example,

the franchisee may function as an agent for the franchisor, and the legal ramifications of agency cannot be prevented simply by reciting in a franchise agreement that the franchisee is not an agent. Similarly, a franchisee who leaves the franchisor's system and convinces other franchisees also to leave may be liable for wrongfully interfering with the franchisor's rights, even if the franchise agreement is silent on the subject.

A number of laws and regulations specifically deal with franchising. *See* chapter 67, *supra.* The various state and federal franchise laws that govern creation, continuation, and termination of the franchise relationship must be carefully understood before a franchise system is structured. These laws work in three ways to regulate franchises. First, they specify the required content and delivery of information to prospective franchisees. Second, they may require a franchisor to register with state authorities before offering franchises within the state. Third, they regulate the business relationship between a franchisor and its franchisees, particularly in reference to establishing, terminating, renewing, or modifying franchises. There are also state and federal laws that govern the antitrust aspects of the franchise relationship.

II. FRANCHISING BASICS

A. (§68.2) Definitions

The term *franchise* is used to describe many different kinds of business relationships. Specific definitions for the word *franchise* are included in the Federal Trade Commission (FTC) Franchise Rule and in Oregon laws and administrative rules, set forth in ORS chapter 650 and OAR chapter 441, division 325. *See* chapter 67, *supra.*

Although the technical definition of a franchise varies according to the applicable law, the typical elements of a franchise include the following:

(1) The transfer of products, know-how, and proprietary information by the franchisor, either as a product to be distributed by the franchisee or as a business format to be followed by the franchisee, that enables the franchisee to start its own business;

(2) The related licensing of trademarks or service marks owned by the

franchisor or its affiliate that carry with them public acceptance and goodwill;

(3) Retention of a significant degree of control by the franchisor over or significant assistance with the manner in which the franchisee conducts its business or handles its marketing program; and

(4) A one-time payment or continuing payments by the franchisee to the franchisor for the right to enter into the business. Payments are usually in the form of an initial fee and/or subsequent royalties based on the franchisee's sales.

B. (§68.3) Franchise Development

To outline a successful franchise system plan, a prospective franchisor must look at a number of factors, including marketing strategies, distribution methods, organization structures, accounting practices, financial projections, financial responsibilities, and anticipated market conditions. These factors must be considered in relation to the prospective franchisor's ongoing business operations, market success, business skills, and development objectives.

A franchisor must be well-capitalized; have a tried and tested business idea; develop systems, products, and services that will continually benefit its system franchisees; establish effective communications, operations, recordkeeping, and dispute resolution programs and processes; and be prepared to foresee and manage change in its competitive environment and franchise system culture.

1. (§68.4) Franchise Feasibility Study

One of the first steps to establish a franchise system is to determine whether the system is feasible given market conditions, the prospective franchisor's business experience, and the current product or service development efforts. A wise prospective franchisor thoroughly analyzes whether it is in a position to adequately administer the system, whether it can support its franchisees and at what cost, and whether franchise system development is more appropriate than the other standard forms of business expansion. *See* §68.6, *infra*.

The prospective franchisor also must analyze the franchise opportunity from the franchisee's viewpoint. The feasibility study must determine whether a prospective franchisee can operate profitably in the marketplace, whether the

system has or can develop sufficient consumer demand for its products and services, and whether market competition will keep the franchise system from developing or making a profit.

If either the franchisor or the franchisee cannot fully benefit from a franchise method of operation, then the franchise system will not be successful. The failure of either party results in the failure of the other.

The next step in determining the feasibility of franchise development is to focus on the goods or services to be offered to the public. Among the factors to be assessed are market potential, competition, the target market, and marketing strategies and policies. It is important to consider the nature of the locations where franchisees should place their outlets to successfully market and how best to find these locations. This analysis requires studies of population density and demographics in the relevant local markets. Cost and price structures, promotional materials and advertising campaigns, and franchisee marketing strategies also must be considered.

One critical section of the feasibility study must deal with management. It is common knowledge that lack of capital and poor management are the two main causes of business failure. The feasibility study must identify the necessary organizational structure for the franchise system. It should also determine the management requirements for successful day-to-day franchise business operations. The prospective franchisor must establish guidelines, procedures, policies, and training practices to enable each franchisee to deal effectively with its employees and customers. Sufficient flexibility must be incorporated to allow each franchisee to meet the changing circumstances and peculiarities involved in its local market. The prospective franchisor should analyze personnel management policies, franchise business functions, the allocation of management authority between the franchisor and its franchisees, and franchise unit monitoring and evaluation programs.

Accounting records are valuable aids to making management decisions. These aids are especially important in a franchise system when overall business health can be monitored and appropriate remedial diagnoses made as a result of the information gathered through periodic reports. This means a prospective franchisor must analyze two different accounting aspects in determining the feasibility of establishing a franchise system. First, the franchisor must estimate income,

expenses, cash flow, and investment required at various points in the system. The franchisor must anticipate debt and equity requirements on behalf of the franchisor and for each franchisee, and study standard balance sheet, income statement, and cash flow statement projections. Other factors to be considered include sources of capital available through equity and loan sources, working capital requirements, and break-even analysis. Second, the franchisor must analyze accounting materials with an eye on reports to be made by a franchisee to the franchisor. Recordkeeping journals, financial requirements, and accounting systems must be developed or refined.

In the United States, state and federal laws directly affect impact the establishment of a franchise system. These laws can be traps for the unwary entrepreneur, accountant, or lawyer. Legal assistance from experts well versed in state and federal franchise law is imperative. Among the factors to be covered in the legal part of the feasibility study are the establishment of a business structure, trademark and patent development and registration, creation of franchise disclosure and contract documents, and regulatory compliance specifically related to the franchised services and products (including state and local permit and licensing requirements).

The final phase of the feasibility study should involve creating a franchisee "profile." The prospective franchisor must consider the kind of person who would be the ideal franchisee to have the maximum probability of success. How best to attract and identify that person can then be determined.

2. (§68.5) Providing for Change

Every good franchise system grows, develops, and matures. As this happens, modifications of business format, goods and services to be provided, and customer identity are likely to occur. A franchise agreement can be designed to allow this development. It is important to provide flexibility to make changes while maintaining uniformity and consistency throughout the franchise system.

A prospective franchisor will find it necessary to compile its accumulated know-how and experience into an operations manual. The manual should provide in detail the procedural requirements, operating standards, day-to-day business functions, and establishment and maintenance requirements for the franchisee.

Accounting systems, inventory control procedures, advertising and promotional programs, training processes, and the franchise support package will all be detailed in the operations manual. Operations manuals are commonly used to add new items or services to those that the franchisee must sell or perform. The manual may designate new, approved, or required supply sources and revised requirements for business location, business appearance, or both. Often franchisors use their operations manuals to reinforce existing contractual requirements, to institute new procedures, and to identify additional assistance and services that can help the franchisee.

It can be difficult to draft a franchise agreement that is general enough to allow for future modification but specific enough to guide the parties throughout the life of the contract. By referring in the agreement to the franchisor's operations manual, the franchisor may be able to strike this critical balance. The franchise agreement should specifically refer to the operations manual and obligate the franchisee to comply with it. The agreement ought to permit the franchisor to modify the manual from time to time, as the franchisor deems appropriate, to preserve the goodwill and business advantage of the franchise and the franchise system. The franchisor will want the agreement to state that these unilateral modifications may have a broad scope but will be reasonable.

Any changes or modifications made in an operations manual must be reasonable. If they are not, the changes may be found to be unenforceable despite provisions to the contrary in the franchise agreement. The changes must be consistent with the franchise agreement and reasonably anticipated by the franchisee when the parties executed the franchise contract. The reasonableness of a change depends in part on the following factors:

(1) The magnitude of the change in reference to the franchise system and the franchise agreement;

(2) The financial effect on the franchisee;

(3) The need for consistency and uniformity among franchisees;

(4) The effect of the change on the franchisee in competing in the marketplace outside of the franchise system; and

(5) The effect of the change on the franchise system as a whole.

C. (§68.6) Alternatives to Franchising

In addition to franchises, a number of choices are available when selecting a business format to start a new business or expand an existing one. The most common alternatives to franchising are outlined below. An in-depth analysis should be made to determine how best to expand. In that analysis, be careful to avoid inadvertently creating a regulated “franchise,” “business opportunity,” or “security.” Caution, competent advice, careful planning, and strict adherence to the plan are critical.

The alternatives include the following:

(1) Company-owned operations;
(2) Joint ventures;
(3) Subcontracting;
(4) Agents, manufacturer’s representatives, brokers, and consignees;
(5) Cooperative associations;
(6) Traditional wholesaling through distributors or dealers;
(7) Consulting services;
(8) Management agreements;
(9) Gross leases of existing business operations;
(10) Licensing of know-how; and
(11) “Business opportunities.”

Every business involves making decisions concerning capital structure, budget, form of business organization, creation of business goals, and tax planning.

The objectives, circumstances, and resources of a business influence which of the alternatives for expansion should be selected. For example, a company with sufficient capital assets may limit its review to self-funded growth, but a company without liquid assets may not be able to finance itself. A business with flexible decision-making systems may want to use alternatives that delegate to entrepreneurs a part of the decision-making process, but a company in a highly sensitive industry

(e.g., high-tech, health care, pharmaceutical) may not be able to risk giving autonomy to its distributors or partners.

Important planning, legal, and regulatory consequences flow from the alternative chosen. In many states, a broad range of these alternatives is governed by state business relationship or business regulation laws. These laws might apply

regardless of the name given to the relationship by the involved parties.

The more commonly used alternatives include the following:

(1) *Company-Owned Units.* Vertical integration allows for greater control and maximum profit. A company that has sufficient capital, available personnel, and a confined market can grow through internal expansion. A business that must tightly control pricing or product distribution may have no choice but to use company-owned retail outlets. The same is true for businesses in which market or customer allocation among outlets is important.

(2) *Joint Ventures.* Joint ventures involve a business and a partner. These relationships are often used when expansion into unfamiliar markets or large or complex deals are contemplated. The partner is selected because of some special expertise, market knowledge, financial or business capacity, or other advantage not available to the business.

Joint ventures, whether in the form of a partnership, a limited partnership, a shared equity arrangement, a corporation, or a simple contractual relationship, are usually individually negotiated in reference to the particular circumstances of the parties. Significant securities, antitrust, and business law ramifications may be involved and should be carefully considered.

(3) *Independent Agents.* A system of agents, representatives, brokers, or consignees works well when control over day-to-day business operations is not a high priority or if name identification is not part of the program. Perhaps the most difficult aspect of doing business in this manner is giving the independent party enough flexibility to perform the work while imposing enough basic controls to maintain professional standards. Also, special attention must be given if the system includes either name identification or assistance in or control over marketing processes because state, provincial, and federal franchise, business opportunity, or employment laws may apply.

(4) *Cooperative Associations.* Groups of businesses that would otherwise be competitors can get together to take advantage of the economies of scale available for cooperative purchases or advertising. Significant antitrust and franchise law pitfalls must be identified and avoided.

(5) *Traditional Wholesale Programs.* A standard approach for many businesses that sell products is to sell to independent retail dealers. The sale is often at wholesale prices for unlimited retail distribution. Sometimes the resale is to be

limited to particular markets or territories. Control over the retail dealer is limited in this approach and care must be taken to maintain product or service standards and the integrity of related goodwill.

(6) *Licenses and Business Opportunities.* A license is broadly defined to include every relationship under which a person is given the right (usually for a fee) to exploit a name, system, process, or procedure that belongs to another business or is known only to that business. Because of the costs of complying with government disclosure and registration requirements pertaining to franchises, a person wishing to sell a business format that does not rely on a trademark or service mark for its success should consider using a license agreement rather than creating a franchise. The basic business terms of a license agreement could be the same as a franchise agreement, with the exception that the licensor would prohibit the licensee from operating the business under any particular name, trademark, or service mark.

(7) *Distributorships.* A person who wishes to sell a product through outlets established by others should consider using a distributorship as an alternative to franchising. It takes more than changing the name of a business from *franchise* to *distributorship*, however, to avoid the necessity of complying with the franchise disclosure laws. Franchises and business opportunities (as defined by state, provincial, and federal laws) are special kinds of licenses. *See* §68.8, *infra*. Sometimes arrangements that attract unsophisticated persons are marketed with assurances that there is no risk. This type of program may involve "business opportunity" laws. Arrangements that require substantial decision-making by persons in all levels of the chain of distribution, or involve highly structured organizations that share trade name identification, may be subject to state and federal franchise laws.

D. (§68.7) Some Alternatives to Expand a Business Through Franchising

In some cases, a franchisor will be unable to sell franchises in all markets as rapidly as the franchisor would wish, either because of a lack of sufficient capital or personnel or because of time limitations. As a result, a franchisor may license to others the right to sell and service franchises in a given territory. Such a license is

called a *subfranchise, area development franchise, regional franchise,* or *master franchisee license.* In this chapter, the seller of a subfranchise is called the *franchisor* , the buyer is called the *subfranchisor,* and the individual franchise owners who purchase their rights from the subfranchisor are called *subfranchisees.* Typically, the subfranchisor is given the exclusive right to sell franchises within the described territory, and often has chief responsibility for providing training and assistance to the individual subfranchisees during the life of their franchise agreements. The degree of responsibility for servicing the individual subfranchisees, as well as the share of revenues generated by subfranchisees, can be allocated between the franchisor and the subfranchisor in any manner the parties choose. Variations on this theme include granting a single franchisee the right to develop a specified or unlimited number of franchise units in a defined territory through an *area development agreement* or a *multiple unit agreement.* Some franchisors grant multiple unit or area development rights through an addendum to the franchise agreement. Others create specific contracts for that purpose.

Extreme caution and expert counsel must be used if a subfranchise relationship is contemplated. Significant registration, disclosure, and vicarious liability issues arise in this context.

Some franchisors employ outsiders to assist in marketing their franchises, but execute all franchise agreements directly with the individual franchisees and provide all subsequent training and assistance. In those cases, the outsiders are properly called *franchise salespersons* or *brokers.*

Similarly, some franchisors make all sales themselves but employ independent companies or persons with limited authority to assist them in servicing franchisees. These parties typically are independent contractors or employees, not subfranchisors. The distinction may make a significant difference in the form of disclosure documents required by state and federal law, and the extent of liability to individual franchisees.

In formulating its franchise disclosure rule, the FTC had great difficulty in distinguishing between product franchises covered by the rule and producer-distributor relationships that were not covered. In its compliance guide, the FTC made use of the supplier’s trademark as the key to coverage by the disclosure rule. The FTC “does not intend to cover package or product franchises in which no mark is involved. If a mark is not necessary to a particular distribution arrangement, the

supplier may avoid coverage under the rule by expressly prohibiting the use of its mark by the distributor." 2 Bus Franchise Guide (CCH) ¶6205 (1980 & Supps).

Thus, a true distributorship may be created with certainty by outright prohibiting the use of the supplier's mark. Even when use of the mark is not prohibited, a distributorship still will not be a franchise under the FTC franchise disclosure rule unless the rule's three elements are met: (1) distribution of goods and services associated with the franchisor's trademark, (2) significant control of, or significant assistance to, the franchisee's method of operation, and (3) required payments by the franchisee to the franchisor.

Caveat: Although a distributorship may be exempt from the FTC disclosure requirements, a franchisor or supplier should be careful to examine pertinent state franchise and business opportunity laws, because the definitions of *franchise* and *business opportunity* under state law differ significantly from FTC provisions, and some states have specific statutes regulating certain forms of distributorships. *See* §68.8, *infra;* Appendix 67A.

E. (§68.8) State and Federal "Business Opportunity" Laws: Traps for the Unwary

Federal or state laws that relate to opportunities to invest in business ventures can be broadly categorized into four categories: securities, franchise, unlawful trade practices, and business opportunities laws.

Securities laws vary greatly among states. This chapter does not address them further. *See* 1 Advising Oregon Businesses chs 17–18 (Oregon CLE 2001).

Unlawful trade practices acts vary greatly from state to state. A state consumer protection, unlawful trade practices, or fraud act ("Little FTC Act") generally protect against false, misleading, unfair, and deceptive actions. Most Little FTC Acts allow a person to pursue a variety of remedies. Some acts are limited to protection of "consumers," and the definition of *consumer* varies from state to state. *See generally* Consumer Law in Oregon (Oregon CLE 1996 & Supp 2000). In some

states, the definition is broad enough to include franchises and business opportunities. In many states, the Little FTC Acts specifically refer to and interact with the franchise and business opportunity statutes.

About 25 states enacted business opportunities laws to prevent consumer fraud schemes that were common throughout the United States several decades ago involving the sale of "start-up" businesses to "unsophisticated persons." *See* §67, *supra*. The statutes regulate the kinds of business ventures that were prevalent when the statutes were adopted. For example, most statutes regulate or prohibit work-at-home opportunities, vending machine routes, chinchilla ranches, worm farms, video game routes, pyramid sales programs, discount coupon book programs, and other "can't miss" schemes.

Comment: Most business opportunities laws describe themselves as registration and disclosure rules. In reality, their primary focus is to allow public officials to quickly find and weed out fraudulent business opportunities promoters when they appear. For further discussion, see §67, *supra.*

Many common and legitimate business programs can be caught in the extensive web of business opportunity laws. Franchises, subcontractor agreements, authorized manufacturer contracts, licenses, distributorships, and joint ventures can inadvertently fall into the business opportunities trap. The result of violating these laws can include the following:

(1) Cease-and-desist orders;
(2) Criminal prosecution;
(3) Criminal fines;
(4) Revocation of exemptions;
(5) Felony criminal prosecution;
(6) Asset seizures;
(7) Unlawful trade practices actions (including punitive damages and attorney fees); and
(8) Civil remedial law suits (rescission, damages, and punitive damages).

A businessperson risks a great deal by violating, either inadvertently or purposefully, state or federal business opportunities laws. Careful attention to these laws is critical when preparing a distribution program. *See generally* §67, *supra*.

F. (§68.9) Franchise Legal Documents

The FTC rule governs the franchise offer and sales process. This rule is discussed at length in §67, *supra*. In general, the FTC rule, 16 CFR part 436, serves

two principal functions. First, it prevents the fraudulent misrepresentation of material facts. Second, it requires the presentation of material facts as a franchisor offers franchises to prospective franchisees.

A *prospective franchisee* is defined as any person who approaches or is approached by a franchisor or franchise broker for the purpose of possibly establishing a franchise relationship. The franchisor must deliver the disclosure information—the franchise disclosure document or "FDD"—to a prospective franchisee in writing. A franchisor must use the FTC rule "FDD" format to make the required disclosures. However, some states have registration or specific disclosure requirements that emphasize or build upon the FTC rule. These states are: California, Connecticut, Florida, Hawaii, Indiana, Illinois, Kentucky, Michigan, Maine, Maryland, Minnesota, Nebraska, New York, North Carolina, North Dakota, Oregon, Rhode Island, South Carolina, South Dakota, Texas, Utah, Virginia, Washington, and Wisconsin. States requiring the registration of franchise offerings may prohibit a franchisor from advertising the franchise until the franchisor has registered.

The FTC rule does not require registration or advance submission of any franchise disclosure document or franchise contracts to the Federal Trade Commission. The franchise laws of the states mentioned above, however, require some form of advance registration or the filing of an application for exemption from their business opportunity laws. Oregon has specific disclosure requirements but does not require registration.) Most of these states require that the franchise disclosure document and contractual documents be submitted for review and approval before franchises can be offered in those states. The documents often must be modified to conform with the relevant state franchise laws. State laws describe the disclosures to be made and also may regulate the relationship between the franchisor and its in-state franchisees. *See, e.g.*, ORS ch 650 and §67, *supra*. To properly prepare a franchise disclosure document, a franchisor must analyze the franchise in light of the disclosure information required by each item.

1. (§68.10) Financial Claims

Perhaps the most sensitive area of franchise sales regulation involves financial claims or "financial performance representations". Some popular franchises have

experienced rapid success. In fact, the word *franchising* to some people is synonymous with *instant success*. Unscrupulous franchise salespersons may use misleading, exaggerated, or fraudulent earnings claims to induce prospective franchisees to invest in a franchise.

A franchisor is not required to make any financial claims or disclosures of franchise sales, revenues, or earnings. If claims are made, they must comply with the FTC rule requirements. Oral, written, or visual representations of financial claims must be supported by disclosure information. There must be a reasonable basis to support the accuracy of any claims. Supporting documentation must be in the franchisor's possession. *See* §67, *supra*.

Although a franchisor need not include any financial performance representations in the franchise disclosure document, which is permitted by the FTC, many franchisors include some minimal, well-established financial representations because prospective franchisees always ask about earnings potential. Furthermore, franchise salespeople and business brokers usually make certain representations to close the sale, even though they have been expressly instructed otherwise. Those unauthorized statements may leave the franchisor liable for rescission or damages at a future date, whereas including a well-established financial performance representation may prevent those statements being made.

Financial performance disclosures and claims must be relevant to the location where the prospective franchisee anticipates operating the franchise. The franchisor should retain complete data to substantiate all claims. The data must be made available to prospective franchisees, the FTC, and relevant state administrators on demand. Financial performance representations and disclosures must be current through the franchisor's most recent fiscal year. *See* §67, *supra*.

2. (§68.11) Franchise Advertising

The FTC rule governs earning claims in advertising for the promotion of franchise sales. Proposed advertising often must be reviewed by the state franchise administrators. State administrators may prohibit the use of franchise advertising or require the franchisor to modify advertising content to comply with state requirements. A wise franchisor will submit all new advertisements and promotional materials for legal and administrative review in draft form before they

are produced in final form for use.

Practice Tip: A franchisor will be liable for misrepresentations even given administrative approval. Do not rely on approval alone to measure the acceptability of the contents of advertisements and promotional materials.

III. ADVANTAGES AND DISADVANTAGES OF FRANCHISING

A. (§68.12) Advantages for the Franchisor

The chief advantage of franchising for the franchisor who has created a successful product or business format is the ability to profit from hundreds of outlets selling the product or employing the format, without having to make the tremendous investment of capital, time, and supervision that would be required to create an equal number of company-owned stores. Although a franchisor incurs certain incremental costs in providing service and training to each new franchisee, those costs are typically a fraction of the cost that could be incurred in establishing a company-owned store. More important, the franchisor is not required to hire personnel and oversee operation of each franchise outlet, and so can operate with a significantly reduced staff. Because the franchisee has invested its own money in the franchised business and views the business as its own, each franchise will be operated more efficiently and with greater dedication than a company-owned store.

For successful franchises, the pyramid effect of a franchise system can create impressive economic returns. Usually, a franchisor does not realize significant profit from the initial sale of new franchises because the sale price is kept low for marketability and often equals training costs. Instead, a franchisor realizes high profits from the ongoing royalties that franchisees pay. Because a franchisor's profitability depends on its franchisees' financial success, a franchisor's best strategy is to select only qualified franchisees and make certain that those franchisees are satisfied and remain in business.

The franchisor also may make a good financial return on the franchisees' purchases of supplies or products. The purchases may be required or optional under the franchise agreement. Typically, however, the franchisee is willing to buy from the franchisor because prices are lower due to the franchisor's quantity buying power.

Another advantage to the franchisor is that, by rapid expansion through franchising, the franchisor's name and marks gain additional public acceptance, which in turn increases demand for new franchise outlets and the franchisor's product. Likewise, funds paid by the franchisees for common advertising create further name recognition that incidentally benefits the franchisor, who retains ultimate ownership of the name and marks.

Finally, through franchising, the franchisor can limit the usual business risks resulting from expansion and can avoid some sale liability problems, labor problems, and multiple taxation problems.

B. (§68.13) Disadvantages for the Franchisor

The franchisor should consider several potential disadvantages. Simply calling an idea a *franchise* will not guarantee its success. The product or format must in fact be attractive to the public and fully tested for subsequent franchising to succeed. Franchises that do not represent tested, market-accepted products or formats may fail, generating franchisee unhappiness and considerable litigation.

Similarly, too rapid expansion may leave the franchisor unable to fulfill its commitments to its franchisees and cause the system to fail. In other cases, if the franchisor drives too hard a bargain or oversells its franchise agreement, it may experience a high rate of franchise failure, which will reduce the favorable economics of the royalty payments described in §68.12, *supra.*

In early years, a franchisor may be so anxious to expand that it sells its franchises too cheaply or grants exclusive territories to subfranchisors at prices that are too low or for periods that are too long.

Additionally, the sale of franchises is a tremendously competitive business, and experienced franchise brokers or salespersons will tend to flock to the most successful franchise of the moment. If the franchisor is relying heavily on initial franchise fees from new franchisees, tight credit markets may create a disastrous shortfall that the franchisor is unable to withstand.

C. (§68.14) Advantages for the Franchisee

The chief advantage in purchasing a franchise is that the franchisee can begin

its own business with a reasonably modest investment and a significantly higher chance of success than if the franchisee were to start a business alone. This success occurs because the chief elements that the franchisee purchases via the franchise—training, a proven, successful product or business format, and publicly recognized names and marks—permit the franchisee to start successful operations and win public acceptance in a relatively brief period.

For this reason, it is absolutely essential for the franchisee to independently investigate the franchise before buying to be certain it has the promised level of public acceptance and potential success as a business. Careful market research by the franchisee, including conversations with the existing franchisees listed in the franchise disclosure document delivered by the franchisor, can help a franchisee avoid a disastrous investment. If the franchisor does not yet have any successful franchise outlets, presents incomplete franchise disclosure documents and contracts, or has not perfected the franchise system, even more market research and price negotiation are necessary.

Other advantages to a franchisee are greater independence than would be found in working for a company-owned store, an exclusive territory for the franchise business according to the terms of the franchise agreement, and broad assistance from the franchisor in training, accounting, quantity purchasing, product pricing, quality control, and personnel supervision.

D. (§68.15) Disadvantages for the Franchisee

Potential disadvantages for the franchisee include the following:

(1) The franchisor's significant and sometimes overpowering retention of control concerning conduct of the franchise business;

(2) Unfair provisions in the franchise agreement concerning transfers and renewals of the franchise business;

(3) The franchisor's retaining an option or first-refusal right that can cause the franchisee to lose its goodwill and other investment in the business;

(4) The potential for excessive franchise fees; and

(5) The franchisee's obligation to continue paying a percentage of gross monthly revenues to the franchisor long after the franchisor has

ceased to provide any significant assistance to the franchisee and regardless of

whether the franchisee is making a profit.

Many of these potential disadvantages are mitigated by the franchisor's strong interest in the financial success of the franchisee.

In addition, through over-commitment, inadequate financing, or product or trademark disputes, the franchisor may be unable to fulfill its commitments to the franchisee, or may even lose its rights in the franchise system. This problem arises particularly when the franchisee purchases a franchise from a subfranchisor. The franchisee always should examine carefully the franchise agreement and the franchise disclosure document to determine precisely who owns the rights to the franchise system and whether those rights can be terminated or altered to the detriment of the franchisee.

IV. (§68.16) ELEMENTS OF THE FRANCHISE AGREEMENT

Note: Sections 68.17–68.41, *infra*, contain material condensed from Franchising, a handbook authored in part by Douglas D. Smith and James H. Bean, edited by Professors Robert Justis and Richard Judd, and published by South-Western Publishing Co. (1989). Reprinted by permission.

Sections 68.17–68.41, *infra,* summarize franchise contract terms often used by franchisors. It is beyond the scope of this chapter to explain all the financial, business, and legal ramifications of these terms. Potential antitrust problems must be considered by legal counsel in regard to many of the following points.

Many franchise professionals are now preparing franchise documents and agreements in the "you/we" format and in plain English, following the FTC rule guidelines for preparation. In addition, a significant movement has developed among some franchisors to create franchise agreements that take some system-wide control, dispute resolution, and relationship regulation functions out of the individual franchise agreement and place them in "umbrella" agreements between the franchisor and cooperative associations of its franchisees. This is especially true in well-developed systems with many franchisees.

A. (§68.17) Introductory Section and Parties

The beginning of the contract lists the parties to the franchise agreement, the nature of the franchise system, and the identity of the names and symbols associated with the franchise. Any special materials, patents, copyrights, or other important parts of the system may be discussed in the introductory section.

Both the franchisor and the franchisee should be careful to state exactly who are the parties to the agreement, and should be certain that the agreement is executed in the proper form for each party. This step is important for the franchisee in determining who is liable for providing performance to the franchisee, and in checking the extent of the franchisor's rights in the franchise system, such as whether the franchisor only has limited rights as subfranchisor, or whether some performance will be provided to the franchisee by a party other than the franchisor.

Careful identification of the parties is even more important to the franchisor because many provisions in the franchise agreement relating to protection of proprietary information, competition with the franchisor, restrictions on transfer and assignment of the franchise, and obligation to make payments will be binding only on the parties who execute the agreement. When the franchisee is signing the agreement as a corporation, the franchisor additionally may wish to require the signature of the principals or owners of the corporation as guarantors for all payments, and to bind them to the other specific provisions listed above. Another method of binding persons connected with the franchisee is to require execution of collateral agreements by the principals, owners, and employees of the franchisee.

B. (§68.18) Contract Duration and Renewal

The term of the agreement and the franchisee's ability to renew are of vital importance to the franchisee. Typically, a franchise term will run from four to 20 years and be renewable by the franchisee, as long as not then in default, on the same terms and conditions contained in the franchisor's then-used standard agreement. This formulation permits a degree of financial certainty and continuity for the franchisee, because the franchisor will be limited in its ability to alter the franchise agreement by market considerations existing at the time of renewal. This formulation also gives the franchisor flexibility to introduce new terms and conditions in the franchise agreement from year to year.

The franchisor should avoid open-ended or indeterminate franchise

agreements. These agreements could prevent future modifications without the consent of the franchisee, including modification of royalties, products, or performance, and could give the franchisee a common-law right to recoupment in the event of termination.

Typically the franchisee must give notice of intention to renew some period of time before the franchise agreement expires. This notice allows the franchisor to make arrangements for a new franchisee if the existing franchisee does not renew the agreement. Similarly, a lengthy notice period gives the franchisor time to present the new franchise agreement and resolve any pending disputes before the actual date of expiration and renewal.

The franchise statutes of some states (e.g., Washington and California) restrict a franchisor's right not to renew or require the franchisor to renew the franchise agreement if the franchisee so requests and is not in default. *See* Cal Bus & Prof Code §20025 (West 1987); RCWA 19.100.180 (1989). Oregon law does not include this provision but an Oregon franchisor usually is bound by such statutes in dealing with out-of-state franchisees, and Oregon franchisees may claim the protection of these statutes in some cases in dealing with an out-of-state franchisor. *See* Cal Bus & Prof Code §20015 (West 1987); RCWA 19.100.160, 19.100.180 (1989).

C. (§68.19) Franchise Fees and Other Payments

The franchisor should be careful in defining the initial fee and royalties that the franchisee must pay. In particular, the franchisor should provide a specific formula for determining the amount of continuing royalties. Typically, royalties are paid on a monthly basis as a percentage of the franchisee's gross revenue, often in the range of 5% to 10% of revenue. Gross revenue is a much easier quantity to measure than net revenue or net profit, which avoids unnecessary disputes. Because royalties are tied to sales, the franchise agreement should also prescribe minimum hours or days of operation.

The franchise agreement typically requires the franchisee to complete monthly and other periodic reports on forms provided by the franchisor, and to follow an accounting system in a form prescribed by the franchisor. This system simplifies the franchisor's job of policing compliance with payments requirements. The

franchise agreement frequently includes a minimum monthly royalty that must be paid whether or not the franchisee has received any revenues.

The franchise agreement also usually requires the franchisee to provide an annual audited or compiled financial statement from outside accountants, and additionally grants the franchisor the right to dispute the figures and have the franchisee's books and records reaudited. Under this provision, if the audit finds that the franchisee's revenues were understated by a certain percentage (e.g., 1% to 4%), the franchisee not only must immediately pay all past-due royalties on the understated account but also must pay for the cost of the audit.

The franchise agreement often specifically denies the franchisee the right to set off its obligation to pay royalties against any claims it believes it has against the franchisor.

The franchisee should look carefully at the formula for measuring royalties, and may wish to negotiate a reduction in the percentage royalties and the monthly minimum payments during the first few months of operation. Similarly, when payments are made to someone other than the master franchisor (e.g., to a subfranchisor for the franchisee's area), the franchisee should look for provisions protecting it against misapplication of payments or failure to pass on the royalties to the proper party.

D. (§68.20) Sales of Goods or Services to the Franchisee

A franchisor can describe the nature, amount, and minimum requirements for materials that the franchisee must have on hand at the franchise. If the franchisor is not the sole source of supply, the franchise agreement may list approved suppliers and provide methods to approve new suppliers.

E. (§68.21) Financial Reporting and Auditing

Usually the franchisee is obligated to submit to the franchisor a periodic report on the financial performance of the franchise. Ongoing fees are often paid with and based on these reports. Many franchisors reserve the right to have these reports audited by either the franchisor, the franchisor's accountants, or independent auditors. Most franchise agreements require the franchisee to pay the costs of the

audit if significant errors or underreporting is discovered in the franchisee's reports.

F. (§68.22) Site Selection and Territory Designation

The franchise agreement should set forth the franchisee's territory with specificity, and should clearly indicate whether the franchisee's rights are exclusive or nonexclusive (i.e., whether the franchisor can grant additional franchises to others or establish company stores within the territory). Most commentators suggest that all franchise rights and

territories be granted nonexclusively to avoid potential conflicts and future misunderstandings.

Some franchise businesses involve selling and shipping products or providing services to customers in areas outside the franchisee's territory. In those cases, the franchisor should include provisions clarifying the responsibility of each franchisee for transactions occurring across multiple territories. For example, when the franchise involves selling a product with ongoing warranty and service obligations, the franchisor may want to provide in the franchise agreement that the selling franchisee is obligated to pay a portion of the sales price to the franchisee who is located in the territory where the product was shipped. In return, the franchisee who receives a portion of the sales price would be obligated to provide warranty care and servicing to the purchaser for the duration of the obligation. Alternatively, franchisees may be required to refer sales prospects to the franchisee whose territory includes the prospective buyer, in exchange for a stated share of sale proceeds. Except when all sales are made on the premises of a franchisee, careful consideration should be given to allocating responsibility for transactions among franchisees.

There are a number of ways an unwary franchisor can cause or allow encroachment into a franchisee's protected territory. They range from purposeful or negligent trade in the territory, to not restructuring other licensees from trading in the area, to offering services or products in the area through alternative channels of commerce. *See generally* Ronald R. Fieldstone, *Franchise Encroachment Law*, 17 Franchise LJ 75 (Winter 1998); John F. Dienelt, *Carvel Encroachment Decision Ensures Continued Debate*, Franchise LJ at 1 (Fall 1997); *Anatomy of an Encroachment Case*, ABA Forum on Franchising (Oct 1997).

G. (§68.23) Business Site Preparation

The franchise agreement should specify any requirements of the franchisee or the franchisor concerning the setup of the franchise location. Confidential matters can be referred to in the agreement and more specifically outlined in the confidential operations manual.

H. (§68.24) Franchise Site Leases

Some franchisors obtain the premises for the franchise and then lease or sublease it to the franchisee. Other franchisors require the franchisee to obtain particular lease provisions when the franchisee is leasing the premises from third parties. One common provision is to have the landlord consent to the franchisor's assuming control of the premises if the franchisee's franchise agreement terminates or expires.

I. (§68.25) Trademarks, Service Marks, and Other Commercial Symbols

The parties should identify the marks that are currently part of the franchise system. Because of the difficulties sometimes encountered in protecting marks, most franchisors leave themselves free to take (or not) action to protect the marks as the circumstances warrant. If protection of one or more of the marks is too difficult or impossible, most franchisors require the franchisee to adopt new or modified marks from time to time as the franchisor may direct.

J. (§68.26) Use of Trade Names and Operating Procedures

The franchisor's trademarks and service marks, associated with desirability and quality in the public mind, are at the heart of a franchise system. Without those marks, the value of the franchise is considerably lower.

Some franchisors fail to engage in sufficient planning at the start of the enterprise in selecting effective, protectible trademarks and service marks that will

carry a strong identity. Effective marks enhance the saleability of franchises and avoid the defection of established franchisees. Among other considerations, the franchisor should avoid choosing marks that consist of merely descriptive words or terms, which cannot be registered unless a secondary meaning is established. A franchisor also should avoid adopting any marks that infringe on existing marks, which can give rise to litigation and may limit the franchisor's rights in certain geographic areas. Last, a franchisor should establish a system to discover and prevent infringement of its marks to maintain its rights and the value of its system.

The franchisee should carefully read the franchise disclosure document to determine precisely who owns the franchised marks, whether the marks have been filed with appropriate authorities, and whether the marks are likely to receive legal protection if challenged. Similarly, the franchisee should determine whether the franchisor guarantees the validity of the marks, has any obligation to defend the marks, and has retained the right to substitute other marks for the marks originally licensed under the franchise agreement.

In the same fashion, the franchisee should determine precisely who owns the underlying rights to the franchise product, patent rights, and

proprietary information that the franchisor is selling. The franchisee should obtain a warranty of ownership by the franchisor, and in this connection should look for disclosure of interests held by other parties. If celebrity endorsements are important to the franchise, the terms of any agreement with celebrities should be determined.

If the franchisor's rights are in fact limited, the franchisor should disclose that fact. The franchise agreement should include a provision permitting the franchisor to substitute other products, marks, or endorsements if the franchisor loses its rights, or permitting termination or an equitable abatement of the fees or royalties.

K. (§68.27) Promotion and Advertising

Many franchise agreements require each franchisee to pay an additional monthly fee (e.g., 1% of monthly gross revenues) to an advertising fund controlled by the franchisees or by the franchisor jointly with the franchisees. These amounts are used for regional and national advertising for the benefit of all franchisees. The advertising is additionally beneficial to the franchisor, because it heightens public recognition and acceptance, increases royalties from sales, and enhances

marketability of new franchises. Often, a franchisee also must expend a specified amount each month on advertising in the franchise territory.

The franchisee should consider these provisions carefully to ensure that all money paid for advertising will actually be spent for that purpose, and that the franchisor will not be deducting salaries or unjustified overhead from the fund. The franchisee additionally should look for assurances that advertising fees will in fact be spent on advertising in the franchisee's own region, and not for the franchisor's purposes in expanding to new regions. Last, the franchisor may wish to consider creating a franchisee association for the purpose of group purchase of advertising.

L. (§68.28) Training Programs

One advantage of a franchise system is the franchisor's ability to introduce its business concepts and methods of operation to a new franchisee. To be effective, this training must be done efficiently and in a way that maximizes the franchisee's opportunities for successful business operation, especially if the new franchisee has never been in business for himself or herself.

The franchisor's training programs are critical. A prospective franchisee should expect extensive introductory training. Some training will occur at a training center or existing franchise location. This initial training should occur before the franchise opens. Some franchisors even require the franchisee to complete the initial training before expending any funds to obtain a franchise site, inventory, or employees. This training gives both parties an opportunity to see how well the new franchisee functions under the franchisor's methods of operation, and should be mandatory under the franchise agreement. The franchisee's failure to successfully complete the training should allow the franchisor to terminate the franchise (with an appropriate refund of fees). This provision allows the parties to avoid having to endure a potentially dissatisfactory relationship.

Often, initial training is held at the new franchise site, while or just before it opens for business. Many franchisors provide for ongoing training to introduce new concepts, promote understanding of and adherence to the franchisor's standards, and train the franchisee's employees. This training can be done through on-site visits, regional or national seminars or training sessions, and franchisee visits to successfully operating outlets.

M. (§68.29) Inspection and Control

A prospective franchisee must be concerned whether the franchisor has sufficient power to require all its franchisees to faithfully adhere to the franchise methods of operation. It is not in the franchisee's best interest to devote time, energy, and money to making the system work at one location while another franchisee is destroying the image and goodwill of the system somewhere else. Strong contractual rights in the franchisor are the answer.

The nature, timing, extent, and consequences of inspection visits vary among businesses. Quality control and the verification process also vary. A franchisor should devote considerable attention to all aspects of each franchisee's business operations, image projection, and adherence to prescribed methods of operation.

N. (§68.30) Managerial Assistance and Business Guidance

Most franchise agreements extensively describe the franchisee's obligations of the franchisee but provide only a general, relatively brief statement of the franchisor's obligations to the franchisee. In fact, in many franchises the franchisor provides little to the franchisee beyond initial training and an operations manual. The franchisee should carefully consider the franchise disclosure document and the corresponding provisions of the

franchise agreement to determine whether the franchisor's promised performance is really worth the price. As noted in §68.19, *supra*, in some cases the franchisee is able to negotiate on the initial payment and royalties, particularly for newly developing franchises.

The franchisee also should consider whether the franchisor intends or will in fact be able to perform under the franchise agreement, and whether the franchise is all that is promised. This determination is best accomplished by talking extensively with other current franchisees, whose names are revealed in the franchise disclosure document or must be provided by the franchisor on request.

Franchisors sometimes face difficulties with established franchisees in later years because the franchisees are no longer receiving the same level of services

from the franchisor as at the inception of the relationship and have established a successful business. To avoid breakaway by franchisees, the franchisor should continue to provide meaningful services to franchisees in later years when royalty revenues from sales are the highest. Additional services can include new advertising, product research and development, developing new markets, methods of dealing with competitors, and additional benefits from volume purchases. Another option is for the franchisor to establish a declining royalty percentage as the franchisee's revenue increases (e.g., considering all franchise outlets owned by a particular franchisee), with the formula tied to an inflation index.

More broadly, a franchisor can avoid franchisee defections by giving all franchisees a role in planning the franchise system evolution.

O. (§68.31) Franchise Business Procedures

Every franchise system is based on both common business practices and specialized (and often confidential) techniques developed by the franchisor. Over time, these practices and techniques may evolve or be changed to improve the franchise system, better meet competition, or reflect the results of ongoing business experience. The franchisor and the franchisee should have a basic agreement about the types of business procedures that each will follow. It is also important to provide ample opportunity for each to adapt to changing competitive environments and to adopt new procedures as necessary. For this reason, most franchisors describe in the franchise agreement the basic procedures to be followed in the franchise system while leaving the specifics to the operations manual, which may be changed from time to time.

P. (§68.32) Products and Services

The franchisor should not attempt to set or control prices that the franchisee charges for products or services sold to the public. Vertical price maintenance is a per se violation of the Sherman Act and many state antitrust laws. *See* chapter 58, *supra*. Some franchise agreements obligate the franchisee to purchase products or supplies from the franchisor or from approved sources only. The franchisor imposes these limits to maintain necessary quality control for the franchisees'

products or services sold and to obtain further profit from product sales. The franchisor may be subject to antitrust liability if the restrictions on the franchisee's purchases are unjustified or overreaching.

The franchisee should object to excessive purchasing restrictions whenever possible. Except when the franchise product itself involves a secret formula or recipe known only to the franchisor (e.g., soft drink syrups or ice cream mixes), the franchisee should require at a minimum that it be permitted to make purchases from outside sources that the franchisor has approved.

In many cases, purchases from the franchisor are less expensive for the franchisee than purchases from independent sources. The franchisee should also consider, however, making group purchases from independent suppliers in conjunction with other franchisees. For this purpose, the franchisee should consider forming a franchisee association.

Q. (§68.33) Insurance

The franchisor runs a significant risk of incurring liabilities due to the franchisee's mistakes or negligence. Even though each franchised outlet is independently owned and operated, the significant degree of control retained by the franchisor and the public's perception of responsibility usually means the franchisor is included as a defendant in any litigation initiated by an injured or a dissatisfied customer.

For this reason, it is essential that the franchise agreement require the franchisee to obtain adequate insurance coverage, that the franchisor be named as an additional insured, and that the franchisee provide sufficient proof of insurance coverage and renewal to the franchisor. Similarly, the franchise agreement should require the franchisee to protect, indemnify, and hold the franchisor harmless for all claims and losses not attributable to the franchisor's acts or omissions. The franchisee should, if possible, obtain similar provisions from the franchisor in connection with claims arising from the franchisor's activities.

Cross-indemnification provisions are especially important when franchises are sold and serviced by a subfranchisor. The master franchisor often is liable for the misrepresentations and negligence of the subfranchisor to the subfranchisee, and should make provision for adequate protection. Likewise, the subfranchisor may be

held directly liable by the subfranchisee for the master franchisor's failure or inability to provide the promised performance under the franchise agreement.

R. (§68.34) Confidential Information

The franchise agreement should place restrictions on the use and disclosure of trade secrets and confidential information related to the franchise business. Nondisclosure obligations can be imposed on the franchisee's managers, employees, owners, partners, and agents. To be legally restricted, persons other than the franchisee may have to execute separate agreements concerning the trade secrets and confidential information. The franchise agreement may require the franchisee to obtain agreements from these persons on behalf of the franchisor.

The franchisor also should include strong provisions acknowledging the franchisor's ownership of the proprietary information being transferred to the franchisee. The provisions should include a promise by the franchisee to protect the confidentiality of and not to disclose the franchisor's proprietary information, and a promise to obtain similar agreements from the franchisee's principals, officers, directors, key employees, and investors. The franchisor should then be certain to enforce its rights by preparing and requiring execution of these agreements from the other parties named, and by obtaining additional agreements from new participants in the franchisee's business from time to time. This step is particularly important when the franchise system involves unique proprietary information that cannot be protected from imitation by any other means.

The franchisee usually will not object to such a provision, although in some cases the franchisor's information is not in fact proprietary or unique but is easily available from other sources. The franchisee particularly should avoid any provisions that attempt to appropriate to the franchisor all improvements, advances, and new ideas originating with the franchisee during the term of the franchise agreement. *See generally* chapter 65, *supra*.

S. (§68.35) Covenants Not to Compete

Covenants not to compete are restrictions on a franchisee operating other businesses that might compete with the franchise system. These covenants are not

favored by the laws of most states and must be carefully drafted to be effective. Covenants not to compete afford a different kind of protection from that gained through obligations of nondisclosure of trade secrets and confidential information.

There are two categories of covenants not to compete. Some are in force during the term of the franchise agreement, and others are in force after the agreement terminates. To be enforceable, a covenant not to compete must be reasonable regarding the duration, geographic scope, and limits that it places on the future employability of the franchisee. *See* chapter 66, *supra*.

The franchisor should always include a strong noncompetition clause to prevent the franchisee from engaging in a business similar to the franchise business, whether as a principal, officer, director, employee, or investor during the term of the franchise agreement and for a reasonable period and in a reasonable locality after its expiration or termination. As noted in §68.19, *supra*, the franchisor's greatest economic benefit from franchising is the ongoing royalties received from franchisees. Without a noncompetition clause, a franchisee could learn all the secrets of the franchise business from the franchisor, then open a competing business or permit the franchise agreement to expire and continue doing business from the same location without paying royalties. Although the franchisee would not be permitted to operate under the franchised name and marks, in many cases the franchisee would count on continuing customer loyalty and goodwill at the franchise location, and would adopt a new format similar to the previous franchised format. The franchisor's restrictions on competition, however, must be reasonable regarding time and geographic area or the court will not enforce the restrictions.

In connection with a noncompetition clause, a franchisor also should consider including a provision that the franchisee agrees that the franchisor's harm from breach of the noncompetition clause is irremediable, that the franchisor is without adequate remedy of law, and that the franchisor is entitled to injunctive relief without bond if the franchisee continues the business in violation of the noncompetition clause. The franchisor also should include a liquidated damages provision to cover the period of time from the franchisee's breach of the noncompetition clause to the time that the clause expires or the time injunctive relief is obtained. The liquidated damages are established as

an amount equal to the monthly royalties that the franchisee previously paid under

the franchise agreement, in effect requiring liquidated damages equal to the same percentage of monthly gross revenues received by the franchisee from its illegal competing business. The clause also should contain the standard recitals for liquidated damages, that is, that the franchisor's actual damages from the franchisee's breach are difficult to compute, but that the amount stated in the liquidated damages clause is a reasonable estimate of damages. This combination of noncompetition clause, right to injunctive relief, and liquidated damages should prevent most franchisees from attempting to copy the franchise system or to avoid ongoing royalties by permitting the franchise agreement to expire while continuing to operate the business.

Even more important, the franchisor should carefully consider exactly who will be bound by the noncompetition clause contained in the franchise agreement. The clauses typically provide that they are binding not only on the franchisee but on the franchisee's principals, officers, directors, key employees, and investors. Unless those other persons in their individual capacities execute the franchise agreement or a collateral noncompetition agreement, however, the enforceability of the clause against those persons is questionable. In such cases, the principals behind a franchisee might leave the franchisee an empty shell when the franchise agreement expires, and commence a new, similar business in their own names and at the same location. The franchisor either should require the principals to sign a separate noncompetition agreement at the inception of the franchise agreement or should require the principals to execute the franchise agreement itself, at least the provisions that are to be binding on them.

The franchisee should try to limit the noncompetition provisions as much as possible, avoid extending the provisions to principals of the franchisee, and try to avoid activation of the noncompetition clause except in cases of the franchisee's breach or failure to renew. *See generally* chapter 66, *supra*.

T. (§68.36) Transfer of Franchise

Transfer of the franchise agreement by either the franchisor or the franchisee can be restricted.

If the franchisee's identity is important to the franchisor, the franchisor should limit the franchisee's right to transfer or assign the franchise agreement. If the

success of the business depends on the unique characteristics of the particular franchisee, then the franchisor should consider an outright prohibition on transfer or assignment. In most cases, however, the better approach is to require the franchisor's prior written consent as a condition of assignment. The nonassignment provision should be worded to apply not only to outright sale of the franchised business but also to sale or assignment of a significant or controlling degree of ownership in the franchisee.

The franchisor should reserve the right to receive all relevant information about the proposed transferee before approval, should reserve the right to require the transferee to execute a new franchise agreement in the form then employed by the franchisor, and should require execution by all parties of an assumption agreement that waives or releases the franchisor from all claims by the transferor under the existing franchise agreement and all claims by the transferee on account of the transferor's statements or misrepresentations. The franchisor also should deny the franchisee the right to assign if the franchisee is then in default under the franchisee agreement, should require payment of all amounts then owing as a condition to assignment, and should clarify that consent to assignment does not release the original franchisee from its obligations or constitute consent to further assignments or waiver of the consent clause. The franchisor additionally may wish to consider imposing a charge to cover any costs of processing the assignment or retraining the transferee, and may wish to reserve the right to deny approval of the transfer if the transfer price and terms of payment are so burdensome that they adversely affect the transferee's future operation of the franchise.

In addition, the noncompetition and confidentiality provisions of the franchise agreement (*see* §§68.34–68.35, *supra*) should continue to apply to the transferor after a permitted assignment or transfer of the business.

In some cases, the original franchisee and the transferee will object to the requirement that the franchisor's current franchise agreement be executed as a condition of transfer because the new agreement may call for higher royalties or other fees than under the original franchise agreement. To make an increase in fees palatable, the franchisor should permit the transferee to sign the new form of agreement for a full new term, rather than only for the balance of the term under the original agreement.

The franchisee should look for transfer and assignment provisions that are

reasonable and that permit the franchisee to give family members or new partners a share of the business, permit continuation of the business if the franchisee dies or becomes disabled, and permit the

franchisee to sell the business in the future and realize a return on the goodwill built up through the franchisee's efforts.

Franchisors often plan to sell their interest in the franchise system once it is established as a success. For this reason, there are seldom restrictions in the franchise agreement on the franchisor's ability to transfer or assign its interest. The franchisee should request such limitations, however, if it is relying heavily on the unique skills or ability of people connected with the franchisor.

U. (§68.37) Right of First Refusal

The franchisor may want to include an option right or right of first refusal exercisable when the franchisee attempts to transfer or assign its business. If considerable goodwill has developed in connection with a particular franchise location, the franchisor will want to realize or recapture some of that goodwill at the time of transfer by the franchisee. A well-designed option or first-refusal clause permits some recapture of the appreciation in value of the franchise business, and permits the franchisor to reacquire particularly valuable sites as company-owned outlets. Conversely, the franchisee will want to avoid any provision that significantly limits its ability to obtain full value when the franchise is transferred to a qualified buyer, or that unduly hampers or delays the sale process. In this connection, the franchisee will want to avoid any option or first-refusal right that requires the franchisee to present all offers to the franchisor for consideration for an extended period because this provision will chill the interest of any potential buyer.

V. (§68.38) Arbitration

Some franchisors include mandatory arbitration clauses in their franchise agreements. Arbitration may provide a quicker, less expensive means of resolving a dispute, and may avoid some of the uncertainties involved in a jury trial for damages. Arbitrators, however, may tend to reach a compromise result even when a franchisor's rights are clear.

In many cases franchisees prefer arbitration because disputes can be resolved more quickly and inexpensively than through litigation and an arbitrator may be more flexible in interpreting the rigid provisions that the franchisor included in the agreement. However, the mere cost to pay the initial filing fee for an arbitration claim (generally to a contractually required arbitration administration agency such as the American Arbitration Association) and the expense to pay the arbitrator for his or her services, may prohibit a franchisee's ability to even bring an arbitration claim.

W. (§68.39) Causes Allowing Either Party to Terminate the Agreement

The franchisee should examine with great caution the termination provisions of the franchise agreement, and should be careful to distinguish those provisions from the expiration and renewal provisions. Whenever possible, the franchisee should obtain the right to receive advance notice of the franchisor's intent to terminate the agreement on account of the franchisee's failings or for other reasons, and a right to cure the reasons for termination. The franchisee should also resist any provision allowing the franchisor to terminate at will.

The franchisor similarly should give extra attention to the termination provisions because most franchise litigation involves the unwillingness of a successful but noncomplying franchisee to be terminated.

Oregon franchise law does not attempt to regulate the terms of the franchise agreement pertaining to termination or refusal to renew. The statutes and case law of other states, however, restrict to a specific good-cause reason the franchisor's ability to terminate or refuse to renew. *See, e.g.*, Cal Bus & Prof Code ¶20020 (West 1987); RCWA 19.100.180(2)(i) (1989).

In connection with the termination provisions, the franchisor should consider reserving the right to take control and operate the franchised unit if the franchisee defaults. This provision enables the franchisor to protect the good name of the franchise system and avoid loss of public goodwill and acceptance of a specific location while finding a new franchisee or making other arrangements.

The franchisee should seek a similar right to terminate the franchise if the franchisor breaches the agreement, although usually the franchisee will not have

sufficient bargaining leverage to obtain termination provisions as favorable as those granted the franchisor. In that case, the franchisee should carefully consider whether the right to terminate the agreement because of the franchisor's default entitles the franchisee to a refund of any money paid, whether it permits the franchisee to continue the franchise business without further royalty payments (either with or without use of the franchise marks), and whether the provisions on noncompetition and confidentiality following termination apply. The franchisee also should consider possible overreaching by the franchisor in the termination provisions, such as provisions calling for mandatory termination if the franchisee dies or is disabled even when the

franchisee's family or personal representative could adequately continue the franchise business.

To avoid litigation, a few franchise agreements permit terminated franchisees a reasonable period, for example, 120 days, to sell the business except when the franchisee is guilty of a serious breach of system standards or intentionally underreporting of sales.

A franchise agreement could also provide for liquidated damages on breach by the franchisee equal to all projected royalties during the term of the agreement, discounted to present value at a stated discount rate. However, these damages usually are difficult to collect.

Last, the franchisor and the franchisee should be careful not to incur antitrust liability by engaging in a combination or conspiracy to terminate another franchisee for anticompetitive reasons. This problem most frequently arises when a franchisee begins making sales or performing services within another franchisee's territory, or at prices greatly below those charged by other franchisees.

Some state contract or franchise relationship laws impose a requirement of "good faith" or "fair dealing" in the conduct and interpretation of the franchise relationship. *See generally* Appendix 67A. This requirement is a topic of current interest and debate among franchise professionals. *See The Duty of Good Faith and Fair Dealing: What Standards Apply?* ABA Forum on Franchising (Oct 1997); *Good Faith and Fair Dealing*, 18 Franchise LJ 174 (Spring 1999); *Good Faith and Fair Dealing—On Both Sides of the Border and Virtually Everywhere*, 21 Franchise LJ 206 (Spring 2001).

X. (§68.40) Obligations of Franchisee on Termination or Nonrenewal

To protect the integrity of the franchise system, most franchisors require a terminated or expired franchisee to take specified actions to either refrain from further business activities in the franchisor's line of business or prevent public confusion between the franchise system and any business continued by the franchisee. Among the things that a franchisor may require are returning operations manuals and trademark-bearing items, modifying the decor of premises that the franchisee retains, transferring telephone numbers and directory listings, preserving confidential information, or terminating the franchisee's business operations.

A franchisee will want to understand all the obligations and ramifications of termination or nonrenewal of the franchise. Sometimes these obligations are harsh and result in the franchisee's having to start over in a new line of business with a loss of customer base, location, and identification.

Y. (§68.41) Bankruptcy

Most franchise agreements provide for termination if bankruptcy proceedings commence, but those provisions may not be enforceable under the federal Bankruptcy Code.

Under the Bankruptcy Code, the typical franchise agreement is an executory contract and subject to rejection or assumption by the debtor-franchisee or trustee in bankruptcy. The franchisor's attempt to terminate the franchise agreement after bankruptcy proceedings commence requires relief from the automatic stay of provisions of the Bankruptcy Code. *See generally* 1 Bankruptcy Law ch 6 (Oregon CLE 1999).

If the franchisor has given notice before bankruptcy proceedings commence of termination effective at a later date, and neither the notice nor the franchise agreement provides for a cure period, or the cure period has already expired, then the termination is effective on the date specified in the termination notice regardless of the commencement of the bankruptcy proceedings. *In re Levine*, 22 BR 16, 18 (Bankr SD Fla 1982). If, however, a cure period is permitted and has not run when the franchisee commences its bankruptcy proceeding, then a prefiling

termination is ineffective and the franchisor must seek judicial relief from the bankruptcy court to pursue further termination action. *Matter of Varisco*, 16 BR 634, 638 (Bankr MD Fla 1981). In other words, a franchisor's attempts to terminate a franchise based on bankruptcy or insolvency clauses of the agreement are unenforceable unless the termination is completed before the bankruptcy proceeding commences.

V. (§68.42) BIBLIOGRAPHY

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CCH Business Franchise Guide
The primary source of up-to-date franchise laws and related industry information. The guidelines for preparation of the FDD are found in §67, *supra*. The various state, federal, and international laws, rules, and regulations concerning franchising and business opportunities, as well as significant court decisions, are summarized and reported in the Business Franchise Guide.

The Forum on Franchising of the American Bar Association
Regularly publishes books and pamphlets related to franchise legal compliance and the franchise relationship. It also publishes copies of the program materials and monographs from its various annual symposia and

forum meetings. For information about currently available publications, contact ABA Publishing, American Bar Association, 750 North Lake Shore Drive, Chicago, Illinois 60611, or visit <www.abanet.org/forums/franchising/home.html>.